CASEBOOK

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I. Agency Law

Robert C. Bolus v. United Penn Bank and Emmanuel Ziobro

Superior Court of Pennsylvania

363 Pa. Super. 247 (1987)

JUDGES: Wickersham, Hoffman and Beck, JJ.

OPINION BY: BECK

The facts of this case can be briefly summarized. Since 1970, Robert Bolus had been engaged in various trucking businesses. He sold trucks and parts for trucks, repaired trucks and towed trucks. In connection with these businesses, Bolus formed two corporations, Key Brockway, Inc. and D.B. & B. Realty Co., Inc. . . . In 1976, Bolus decided to expand his businesses by building a truck repair facility on a tract of land in Bartonsville, Pennsylvania (the "Bartonsville project"). Bolus contacted the Bank to obtain financing for the project.

Bolus was referred to Emmanuel Ziobro, co-defendant below and an Assistant Vice-President of the Bank. Ziobro orally agreed that the Bank would provide the funding for the Bartonsville project. Bolus contended at trial that Ziobro assured him that the Bank would fund the purchase of the land, construction of the facility, equipment and inventory. In September 1976, the Bank lent Bolus One Hundred Thirty-Five Thousand Dollars ($135,000) and Bolus purchased the Bartonsville property and began construction.

In January 1977, Bolus lost a truck dealership he was operating at a different location. He arranged to replace that dealership with another from Freightliner Corporation. Bolus alleges that he informed Ziobro of this fact and on Ziobro's "direction" returned to Freightliner to obtain an additional dealership to be conducted at the Bartonsville location, which Bolus obtained. The acquisition of the additional dealership markedly changed Bolus' plans as to the scope of the Bartonsville project. He needed additional parts and equipment as a condition of conducting the dealership. The total cost of these additional requirements was in excess of One Hundred Thousand Dollars ($100,000). Bolus approached the Bank for the additional funds and the Bank refused to provide them. However, shortly thereafter, the Bank did lend Bolus an additional Seventy-Five Thousand Dollars ($75,000) to fund construction cost overruns at the Bartonsville project.

Bolus' businesses began to collapse in 1978. He eventually lost both truck dealerships and fell behind in his payments to the Bank. The Bank confessed judgment against Bolus in the amount of Five Hundred Thousand Dollars ($500,000), the amount of a Small Business Administration guaranteed loan from the Bank to Bolus, and seized the proceeds of an auction salvage sale Bolus had conducted at another of his business locations. The Bank applied these funds to satisfy Bolus' debt to the Bank as well as certain of his debts to others. Finally, Bolus was forced to sell his properties where he had formerly conducted the two dealerships and the proceeds of those sales were applied to satisfy the Bank's loans.

In April 1980, Bolus and his two corporations instituted this action in trespass and assumpsit against the Bank and Ziobro. Bolus alleged the Bank had breached an oral contract to fund the Bartonsville project, had negligently misrepresented that it would fund the project, and was guilty of the torts of conversion and tortious interference with a contract.

A jury trial commenced. The jury returned a verdict in favor of plaintiffs and against the Bank alone in the amount of $375,000. The Bank filed a timely Motion for Post-Trial Relief seeking judgment N.O.V. or, in the alternative, a new trial. The Motion was denied. . . .

Since we find no merit in any of the Bank's contentions on appeal, we affirm.

1. *Agency of Ziobro*

First, the Bank argues that there was no evidence to show that Ziobro had express, implied or apparent authority to bind the Bank to a lending commitment of the size Bolus alleged that Ziobro made to Bolus on behalf of the Bank. The Bank points to the fact that there was testimony that Ziobro had express authority only to make $5,000 unsecured and $10,000 secured loans. The Bank, therefore, argues that since there was no evidence that Ziobro was acting as the Bank's agent, the Bank cannot be liable either in contract or tort. The Bank draws this conclusion because absent a

showing of Ziobro's agency, the evidence of Ziobro's acts is inadmissible against the Bank and without that evidence, the Bank contends that it cannot possibly be held liable. The Bank thus seeks a new trial because the verdict was against the weight of the evidence.

In reviewing a denial of a new trial where the appellant argues that the verdict was against the weight of the evidence, we must award a new trial only where the verdict is so contrary to the evidence as to shock this Court's sense of justice. In this case, our review demonstrates that the evidence was clearly sufficient to support a finding of Ziobro's agency relationship with the Bank and that as such, Ziobro was clothed with at least apparent authority to bind the Bank to the transactions with Bolus.

It is true as the Bank urges that Bolus had the burden of proving an agency relationship before Ziobro's actions could be attributed to and binding on the Bank. . . . Whether an agency relationship exists is a question of fact for the jury. . . . There are four grounds upon which a jury can conclude that an agency relationship exists and that the principal is bound by a particular act of the agent and liable to third parties on the basis thereof. The jury may find that the alleged agent had:

1) express authority directly granted by the principal to bind the principal as to certain matters; or
2) implied authority to bind the principal to those acts of the agent that are necessary, proper and usual in the exercise of the agent's express authority; or
3) apparent authority, i.e. authority that the principal has by words or conduct held the alleged agent out as having; or
4) authority that the principal is estopped to deny.

As the trial court has indicated in its thorough opinion, further refinements of the foregoing rule indicate that in this case, the jury could have found that Ziobro had at least apparent authority to commit the Bank to a financing obligation of the type that Ziobro made to Bolus.

Without reviewing the evidence in its entirety, we point out that it clearly established that Ziobro was employed as an officer of the Bank authorized to make loans. Although there was testimony that his individual lending authority was limited in amount, there was no evidence that this fact was communicated to Bolus or that Bolus should have concluded that Ziobro's authority was limited. In addition, certain facts of record indicate that one other employee of the Bank himself apparently thought that Ziobro was in charge of all commercial lending at the Bank. When Bolus initially contacted the Bank for financing on the Bartonsville project, this employee told Bolus to speak to Ziobro because he was in charge of commercial lending.

Thus, the Bank itself held Ziobro out to Bolus as being clothed with authority to commit the Bank to provide whatever financing Ziobro reasonably determined to be appropriate under the circumstances. In fact, Ziobro was the only person at the Bank Bolus was ever required directly to deal with to obtain financing commitments for the project. Moreover, Ziobro told Bolus that although there was a loan committee at the Bank that would have to approve the loans, they would basically "rubber stamp" Ziobro's own recommendation and approval and this proved to be true. Since in determining the apparent authority of an agent we must look to the actions of the principal, not the agent, we decide that the foregoing adequately established Ziobro's apparent authority as to this transaction. . . .

The Bank responds that Bolus had to have known that Ziobro could not have bound the Bank simply to finance the entire Bartonsville project since ". . . Banks are not like streams which flow forever . . . . More importantly, such a loan is illegally [sic] as there is no way it could be collateralized and supported as required." However, the Bank has not chosen to provide us with any authority for this statement. Consequently, we have no way of knowing to what legal restriction on the Bank's lending activities it is referring.

As to what Bolus had to have known with respect to Ziobro's authority, we point out that the true inquiry is whether Bolus reasonably interpreted the manifestations of the Bank when Bolus concluded that Ziobro had the authority to bind the Bank to a commitment to fund the Bartonsville project. An admitted agent is presumed to be acting within the scope of his authority where the act is legal and the third party has no notice of the limitations on the agent's authority. A principal's limitation on the agent's authority in amount only that is not communicated to the third party does not limit the principal's liability.

Although a third party cannot rely on the apparent authority of an agent to bind a principal if he has knowledge of the limits of the agent's authority, without such actual knowledge, the third party must exercise only reasonable diligence to ascertain the agent's authority. The third party is entitled to believe the agent has the authority he purports to exercise

only where a person of ordinary prudence, diligence and discretion would so believe. Thus, a third party can rely on the apparent authority of an agent when this is a reasonable interpretation of the manifestations of the principal.

Given the evidence reviewed above, we conclude the jury here could have decided that Bolus acted reasonably in relying on Ziobro's representations as to his authority. We reiterate that Bolus was never required to deal with any other representative of the Bank, that the loan for the purchase of the land and construction of the Bartonsville project that Ziobro promised to Bolus did in fact come through, and that several witnesses testified that Ziobro repeatedly represented his authority and made commitments on behalf of the Bank which proved to be binding without first obtaining the approval of other Bank representatives.

Moreover, in order for Bolus to have believed that the Bank would fulfill the obligations to which Ziobro had committed the Bank, Bolus would not have had to believe that the Bank was agreeing to provide Bolus an endless source of funds. In fact, Bolus has consistently maintained that Ziobro committed the Bank to provide only the funds necessary to set up the project. Even after the Bartonsville project had expanded beyond its original scope, the estimated additional needs of Bolus were only approximately $100,000, which is not an inordinately large sum in the context of commercial transactions such as this.

2. *Inconsistency of Verdict*

The jury found the Bank alone liable to all three plaintiffs and found Ziobro individually not liable. . . . The Bank now argues that the verdict is inconsistent because of the finding of no liability as to Ziobro. . . . . The Bank posits that it could only be found liable for negligent misrepresentation on a theory of respondeat superior as Ziobro's master and that its liability, being purely vicarious, completely depends upon a finding of Ziobro's liability as the Bank's servant.

. . . . we do not accept the Bank's argument. As the trial court has indicated, in this case there was an independent basis for the jury finding the Bank liable. Section 217B of the Restatement (Second) of Agency (1958) states:

> (1) Principal and agent can be joined in an action for a wrong resulting from the tortious conduct of an agent *or that of agent and principal*, and judgment can be rendered against each.
>
> (2) *If the action is based solely upon the tortious conduct of the agent*, judgments on the merits for the agent and against the principal, or judgments of varying amounts for compensatory damages are erroneous.

The Restatement clearly contemplates a situation such as this where there is an independent ground for liability of the principal. In such a case, there is no inconsistency in a verdict for the agent and against the principal. . . .

the Bank's liability, either in tort or contract, is not based upon the rules of vicarious liability of a master for the torts of his servant, but rather on the basis of the Bank's own act in holding Ziobro out as the Bank's agent with apparent authority to make financing representations on which a third party such as Bolus could justifiably rely. . . .

Accordingly, we affirm the trial court's denial of a new trial.

Michael Burlarley, Appellant, v. Wal-Mart Stores, Inc., Respondent

SUPREME COURT OF NEW YORK, APPELLATE DIVISION

75 A.D.3d 955; 904 N.Y.S.2d 826

July 22, 2010, Decided

LEXIS HEADNOTES: Employment Relationships: Respondeat Superior. Defendant was not liable to plaintiffs in action alleging that, after plaintiffs shopped at defendant's store, cashier pretended to ring up plaintiffs' items for more than they were worth and threw various items at plaintiff; cashier's actions arose not from any work-related motivation, but rather her desire to pass time and relieve mounting frustration with her job; nor did employer have any reason to anticipate that cashier would engage in complained-of behavior—inasmuch as cashier acted for purely personal reasons and not in the furtherance of any duty owed to defendant, doctrine of respondeat superior was inapplicable.

JUDGES: Cardona, P.J., Mercure, Malone Jr., Kavanagh and Egan Jr., JJ. Cardona, P.J., Malone Jr., Kavanagh and Egan Jr., JJ., concur.

OPINION BY: Mercure, J.

Appeal from an order of the Supreme Court (Zwack, J.), entered December 29, 2009 in Ulster County, which granted defendant's motion for summary judgment dismissing the complaint.

After an hour of shopping, plaintiff and his wife proceeded to the checkout at defendant's Wal-Mart store in the City of Kingston, Ulster County. The cashier, joking with the pair in an effort to make her work shift "go a little … faster," pretended to ring up items for vastly more than they were worth and threw various items at plaintiff. Plaintiff, unamused, told her to stop, and the cashier initially complied. When plaintiff turned away, however, the cashier threw a bag containing a pair of shoes and shampoo at him. Plaintiff was struck in the face, and this action ensued. Following joinder of issue, defendant moved for summary judgment dismissing the complaint, arguing that the doctrine of respondeat superior is inapplicable because the cashier was not acting within the scope of her employment. Supreme Court agreed and dismissed the complaint, prompting this appeal.

We affirm. The doctrine of respondeat superior renders an employer "vicariously liable for the tortious acts of its employees only if those acts were committed in furtherance of the employer's business and within the scope of employment" [citations deleted]. Factors relevant to a determination of whether an employee's acts fall within the scope of employment include "the connection between the time, place and occasion for the act; the history of the relationship between employer and employee as spelled out in actual practice; whether the act is one commonly done by such an employee; the extent of departure from normal methods of performance; and whether the specific act was one that the employer could reasonably have anticipated" [citations deleted]. While this inquiry generally presents questions of fact, summary judgment is appropriate if the undisputed facts demonstrate that the doctrine is inapplicable [citations deleted].

In our view, Supreme Court properly concluded that throwing a full bag of heavy items at an unsuspecting customer's face as a "joke" is not commonly done by a cashier and, indeed, substantially departs from a cashier's normal methods of performance [citations deleted]. Moreover, the cashier's actions arose not from any work-related motivation, but rather her desire to pass the time and relieve mounting frustration with her job. Nor did the employer have any reason to anticipate that the cashier would engage in the complained-of behavior, in light of the fact that she had worked as a cashier for several years without any significant disciplinary problems. Accordingly, inasmuch as the cashier acted for purely personal reasons and "not in the furtherance of any duty owed to" defendant, Supreme Court appropriately determined that the doctrine of respondeat superior was inapplicable [citations deleted].

Cardona, P.J., Malone Jr., Kavanagh and Egan Jr., JJ., concur. The order is affirmed.

Barbara Pugh, et al. v. Butler Telephone Company, Inc., et al.

Supreme Court of Alabama

512 So. 2d 1317 (1987)

July 31, 1987, Filed

Appeal from Mobile Circuit Court, Robert G. Kendall, Judge.

JUDGES: Houston, J. Maddox, Almon, Beatty, and Adams, JJ., concur.

OPINION BY: HOUSTON

This is an appeal by the plaintiffs, the surviving parents and the estate of Johnnie Carl Pugh, from a summary judgment in favor of the defendant, Butler Telephone Company, Inc. ("Butler") in a wrongful death action. Pugh, an employee of Sandidge Construction Company ("Sandidge"), was killed while working in the line and scope of his employment when the sides of an excavation in which he was working caved in on top of him. There was at least a scintilla of evidence that the excavation in which Pugh was working at the time of his death was neither shored nor sloped and that it violated certain general safety standards. The excavation had been dug the day of Pugh's death by Sandidge, without knowledge of Butler or Joseph D. Fail Engineering Company, Inc. ("Fail"). Sandidge was under contract with Butler to "lay approximately 18 miles of telephone cable" in a rural area. This was a system that had been approved by the U. S. Department of Agriculture, Rural Electrification Administration (REA). Butler's contract was with Sandidge. Fail was the engineer whose responsibility it was to ensure the expeditious and economical construction of the project in accordance with approved plans and specifications. Fail was not to exercise any actual control over Sandidge's employees. The engineering contract between Butler and Fail further provided that Fail's obligations "run to and are for the benefit of only" Butler and the REA administrator.

The plaintiffs' issues for review relate only to the liability of Butler and Fail.

There are three issues presented for review.

The first issue is whether there is a scintilla of evidence to support a finding that Sandidge was an agent of Butler, which finding would enable the plaintiffs to sue Butler for the negligence of Sandidge under the theory enunciated in *Alabama Power Co. v. Beam*, 472 So. 2d 619 (Ala. 1985).

Plaintiffs correctly state that whether a relationship is that of an independent contractor or master-servant depends on whether the entity for whom the work is being performed has reserved *the right of control over the means by which the work is done.* In the absence of a non-delegable duty, the mere retention of the right to supervise or inspect the work of an independent contractor as the work progresses to ensure compliance with the terms of an agreement does not operate to create a master-servant relationship. There must be a retention of control over the manner in which the work is done, before an agency relationship is created. In determining the relationship between Butler and Sandidge, we must review the written contract and the actions of the parties pursuant to the contract.

Our standard of review of a summary judgment granted in favor of a defendant requires us to review the record in a light most favorable to the plaintiff and to resolve all reasonable doubts against the defendant.

The following are all of the provisions of the contract that in any way relate to Butler's retained right of any control:

> (1) Butler reserved the right to require the removal from the project of any of Sandidge's employees if in Butler's judgment such removal was necessary to protect Butler's interest.
>
> (2) Butler had the right to require Sandidge to increase the number of employees and to increase and change the amount or kind of tools or equipment if at any time the progress of the work was unsatisfactory to Butler, but Butler's failure to give such directions did not relieve Sandidge of its obligations to complete the work within the time and manner specified in the contract.
>
> (3) Butler and the REA administrator reserved the right to inspect all payrolls, invoices of materials, and other data and records of Sandidge relating to the construction of the project.

> (4) Sandidge was required at all times to take all reasonable precautions for the safety of its employees on the project and of the public and to comply with all applicable provisions of federal, state, and municipal safety laws and building construction codes. Interpreting the contract most favorably to the plaintiffs, one would conclude that if Sandidge violated this provision, after written notice was given Sandidge by Fail or Butler, Sandidge would immediately correct the violation and if it failed to do so then Butler "may correct such violation" at Sandidge's expense. If Butler deemed it necessary or advisable, it could correct a violation at Sandidge's expense without prior notice to Sandidge.

We do not believe that the contract gave Butler any right of control over the *manner* in which the work was done by Sandidge. Retention of the right to supervise or inspect the work as it progresses to ensure compliance with the terms of the construction contract and the retention of the right to stop work done improperly do not create a master-servant relationship between the entity for whom the work is being performed and the entity doing the work.

There is no evidence in the record that Butler exercised any control or retained any right of control over the manner in which Sandidge performed any of its work on the project. The undisputed evidence in the record shows that Sandidge's employees took their directions in the laying of the pipe or cable exclusively from Sandidge and that Sandidge alone was "running the show and controlling the workplace."

The remaining issues for review are as follows:

Is there a scintilla of evidence to support plaintiffs' contention that Fail negligently failed to carry out its duties under the terms of the contract between Butler and Fail and thereby proximately caused Pugh's death?

Whether Butler may be held liable for the negligence of Fail if Fail violated its contractual responsibilities by failing to be present on the jobsite and if this failure resulted in Pugh's death?

These issues will be discussed together, since we do not find that Fail did not carry out its duties under its contract with Butler.

Fundamental to the maintenance of a negligence action is the existence of a legal duty of care owed by the defendant to the plaintiff. Plaintiffs place great emphasis upon the contractual undertaking of Fail in its contract with Butler. While a party's negligent performance of a contract may subject that party to liability in tort for physical harm to others, . . . the *scope* of that duty, i.e., the persons to whom that duty runs, must be ascertained. Thus, for instance, a workmen's compensation carrier who makes safety inspections of its insured's premises owes a duty of care to the employees of that insured to perform the inspection non-negligently. That same carrier, however, making the same inspection of the same premises, owes no duty to the employees of an independent contractor who are on the insured's premises and who may be injured by a danger the carrier should have discovered. The scope of the duty of care should be co-extensive with the class of persons who were the intended beneficiaries of the inspection, i.e., the class of persons covered by the workmen's compensation policy.

A similar analysis must be made in the present case. Fail's inspections and other activities on site had nothing to do with the safety of Sandidge's employees. Fail's job was to insure compliance with the plans and specifications, for the benefit of Butler, the "owner."

Fail had no responsibility to exercise any actual control over employees of the Contractor. Its responsibilities did not include oversight of safety on the job. Fail was on site simply to ensure compliance by the contractor with the plans and specifications and the terms of the construction contract, for Butler's and the REA administrator's benefit. . . .

In this case, efforts to prove the existence of a duty towards Pugh must fail, because plaintiffs are necessarily relying on nonfeasance, as opposed to misfeasance, in Fail's performance of the contract, i.e., plaintiffs contend that Pugh was killed because of the failure of Breland (Fail's resident engineer) to be at the bore site at the time of the accident.

Under these circumstances, the issue of duty was a question of law, and it was correctly decided by the trial court.

The trial court did not err in granting summary judgment to Butler and Fail. The judgment should be affirmed.

AFFIRMED.

Edgewater Motels, Inc., Appellant-Respondent, v. A. J. Gatzke Respondent-Appellant and Walgreen Company, Respondent

Supreme Court of Minnesota

277 N.W.2d 11

January 26, 1979

JUDGES: Rogosheske, Peterson, and Scott, JJ., and considered and decided by the court en banc. Mr. Justice Otis took no part in the consideration or decision of this case.

OPINION BY: Judge Scott

This matter consists of two consolidated appeals from the post-trial orders of the District Court. Plaintiff Edgewater Motels, Inc., and defendant A. J. Gatzke contend that the trial judge erred by ordering judgment for defendant Walgreen Company notwithstanding a jury verdict which found that Gatzke, a Walgreen employee, negligently caused a fire in plaintiff's motel while he was in the scope of his employment. Plaintiff also claims that the trial judge erred in refusing to set aside a jury finding that plaintiff's negligence caused 40 percent of the damages sustained by Edgewater. We reverse in part and affirm in part.

The fire in question broke out on August 24, 1973, in a room at the Edgewater Motel in Duluth, Minnesota, occupied by Arlen Gatzke. In July 1973, Gatzke, a 31-year Walgreen employee and then district manager, spent approximately three weeks in Duluth supervising the opening of a new Walgreen's restaurant. During that time, he stayed at the Edgewater Motel at Walgreen's expense. On August 17, 1973, Gatzke returned to Duluth to supervise the opening of another Walgreen-owned restaurant. Again, he lived at the Edgewater at the company's expense. While in Duluth, in addition to working at the restaurant, Gatzke remained on call 24 hours per day to handle problems arising in other Walgreen restaurants located in his district. Gatzke thought of himself as a "24 hour a day man." He received calls from other Walgreen restaurants in his district when problems arose. He was allowed to call home at company expense. His laundry, living expenses, and entertainment were items of reimbursement. There were no constraints as to where he would perform his duties or at what time of day they would be performed.

On August 23, 1977, Gatzke worked on the restaurant premises for about seventeen hours. This was the seventh consecutive day that he put in such long hours. One of his responsibilities that day was to work with Curtis Hubbard, a Walgreen district manager from another territory who was in Duluth to observe a restaurant opening and learn the techniques employed. Gatzke's supervisor, B. J. Treet, a Walgreen's regional director, was also present.

Between 12:00 and 12:30 a.m., Gatzke, Hubbard, Treet, and a chef left the restaurant in a company-provided car. The chef was dropped off at his hotel, the Duluth Radisson, and the other three proceeded to the Edgewater, where they each had a room. Upon arrival at the Edgewater, Treet went to his room. Gatzke and Hubbard decided to walk across the street to the Bellows restaurant to have a drink.

In about an hour's time Gatzke consumed a total of four brandy Manhattans, three of which were "doubles." While at the Bellows, Gatzke and Hubbard spent time discussing the operation of the newly-opened Walgreen restaurant. Additionally, Gatzke and the Bellows' bartender talked a little about the mixing and pricing of drinks. The testimony showed that Gatzke was interested in learning the bar business because the new Walgreen restaurant served liquor.

Between 1:15 and 1:30 a.m. Gatzke and Hubbard left and walked back to the Edgewater. Witnesses testified that Gatzke acted normal and appeared sober. Gatzke went directly to his motel room, and then "probably" sat down at a desk to fill out his expense account because "that was [his] habit from travelling so much." The completion of the expense account had to be done in accordance with detailed instructions, and if the form was not filled out properly it would be returned to the employee unpaid. It took Gatzke no more than five minutes to fill out the expense form.

While Gatzke completed the expense account he "probably" smoked a cigarette. The record indicates that Gatzke smoked about two packages of cigarettes per day. A maid testified that the ash trays in Gatzke's room would generally be full of cigarette butts and ashes when she cleaned the room. She also noticed at times that the plastic wastebasket next to the desk contained cigarette butts.

After filling out the expense account Gatzke went to bed, and soon thereafter a fire broke out. Gatzke escaped from the burning room, but the fire spread rapidly and caused extensive damage to the motel. The amount of damages was stipulated by the parties at $330,360.

One of plaintiff's expert witnesses, Dr. Ordean Anderson, a fire reconstruction specialist, testified that the fire started in, or next to, the plastic wastebasket located to the side of the desk in Gatzke's room. He also stated that the fire was caused by a burning cigarette or match. After the fire, the plastic wastebasket was a melted "blob." Dr. Anderson stated that X-ray examination of the remains of the basket disclosed the presence of cigarette filters and paper matches.

The jury found that Gatzke's negligence was a direct cause of 60 percent of the damages sustained by Edgewater. The jury also determined that Gatzke's negligent act occurred within the scope of his employment with Walgreen's. Plaintiff was found to be negligent (apparently for providing a plastic wastebasket) and such negligence was determined to be responsible for 40 percent of the fire damage sustained by Edgewater.

Thereafter, Walgreen's moved for judgment notwithstanding the jury findings and, in the alternative, a new trial. Plaintiff moved to set aside the jury's findings that Edgewater was negligent and that such negligence was a direct cause of the fire. The district court granted Walgreen's motion for judgment notwithstanding the verdict, ruling that Gatzke's negligence did not occur within the scope of his employment, and denied all other motions.

The following issues are presented in this case:

(1) Did the trial court err in setting aside the jury finding that Gatzke's negligent conduct occurred in the scope of his employment?

(2) Did the trial court err in refusing to set aside the jury's findings that Edgewater was contributorily negligent and that such negligence was a direct cause of the damages sustained by Edgewater?

1. The granting of a judgment notwithstanding a jury verdict is a pure question of law. In reviewing the trial court's decision we apply the same standard as the trial court did in passing upon the jury verdict. . . .

It is reasonably inferable from the evidence, and not challenged by Walgreen's or Gatzke on appeal, that Gatzke's negligent smoking of a cigarette was a direct cause of the damages sustained by Edgewater. The question raised here is whether the facts of this case reasonably support the imposition of vicarious liability on Walgreen's for the conceded negligent act of its employee.

It is well settled that for an employer to be held vicariously liable for an employee's negligent conduct the employee's wrongful act must be committed within the scope of his employment. . . .

To support a finding that an employee's negligent act occurred within his scope of employment, it must be shown that his conduct was, to some degree, in furtherance of the interests of his employer. This principle is recognized by Restatement, Agency 2d, § 235. Other factors to be considered in the scope of employment determination are whether the conduct is of the kind that the employee is authorized to perform and whether the act occurs substantially within authorized time and space restrictions. Restatement, Agency 2d, § 228. No hard and fast rule can be applied to resolve the "scope of employment" inquiry. Rather, each case must be decided on its own individual facts.

The initial question raised by the instant factual situation is whether an employee's smoking of a cigarette can constitute conduct within his scope of employment. This issue has not been dealt with by this court. The courts which have considered the question have not agreed on its resolution. A number of courts which have dealt with the instant issue have ruled that the act of smoking, even when done simultaneously with work-related activity, is not within the employee's scope of employment because it is a matter personal to the employee which is not done in furtherance of the employer's interests. [citations omitted]

Other courts which have considered the question have reasoned that the smoking of a cigarette, if done while engaged in the business of the employer, is within an employee's scope of employment because it is a minor deviation from the employee's work-related activities, and thus merely an act done incidental to general employment. [citations omitted] . . . . The question of whether smoking can be within an employee's scope of employment is a close one, but after careful consideration of the issue we are persuaded by the reasoning of the courts which hold that smoking can be an act within an employee's scope of employment. It seems only logical to conclude that an employee does not abandon his

employment as a matter of law while temporarily acting for his personal comfort when such activities involve only slight deviations from work that are reasonable under the circumstances, such as eating, drinking, or smoking.

We hereby hold that an employer can be held vicariously liable for his employee's negligent smoking of a cigarette at the time of the negligent act. Thus, we must next determine whether Gatzke was otherwise in the scope of his employment at the time of his negligent act. . . .

It appears that the district court felt that Gatzke was outside the scope of his employment while he was at the Bellows, and thus was similarly outside his scope of employment when he returned to his room to fill out his expense account. The record, however, contains a reasonable basis from which a jury could find that Gatzke was involved in serving his employer's interests at the time he was at the bar. Gatzke testified that, while at the Bellows, he discussed the operation of the newly-opened Walgreen's restaurant with Hubbard. . . .

But more importantly, even assuming that Gatzke was outside the scope of his employment while he was at the bar, there is evidence from which a jury could reasonably find that Gatzke resumed his employment activities after he returned to his motel room and filled out his expense account. . . . The expense account was, of course, completed so that Gatzke could be reimbursed by Walgreen's for his work-related expenses. In this sense, Gatzke is performing an act for his own personal benefit. However, the completion of the expense account also furthers the employer's business in that it provides detailed documentation of business expenses so that they are properly deductible for tax purposes. . . . Accordingly, it is reasonable for the jury to find that the completion of the expense account is an act done in furtherance of the employer's business purposes.

Additionally, the record indicates that Gatzke was an executive type of employee who had no set working hours. He considered himself a 24-hour-a-day man; his room at the Edgewater Motel was his "office away from home." It was therefore also reasonable for the jury to determine that the filling out of his expense account was done within authorized time and space limits of his employment.

In light of the above, we hold that it was reasonable for the jury to find that Gatzke was acting within the scope of his employment when he completed his expense account. Accordingly, we set aside the trial court's grant of judgment for Walgreen's and reinstate the jury's determination that Gatzke was working within the scope of his employment at the time of his negligent act.

2. Edgewater contends that the jury's findings relating to Edgewater's contributory negligence are not reasonably supported by the record. . . .

The record indicates that Edgewater had notice of its guests' practice of placing cigarette materials in their motel rooms' plastic wastebaskets. The Edgewater maid who regularly cleaned the room in which Gatzke was staying testified that she had seen cigarette butts in the wastebasket in Gatzke's room. . . . In light of these facts, it was reasonable for the jury to find that Edgewater had a duty to protect against the dangers which might flow from its guests' disposal of smoking materials in the motel rooms' wastebaskets. . . .

It is also argued by Edgewater that its use of plastic wastebaskets was not negligent because "the use of such wastebaskets is commonplace." Of course, there is no merit to this contention. . . . Edgewater's conduct must be compared to that of the reasonably prudent motel owner, not that of a similarly negligent one. Edgewater claims that, even if its use of a plastic wastebasket was negligent, such negligence was not a proximate cause of the fire. This contention is premised on the theory that the evidence does not show that the fire originated in the wastebasket.

The reasonable inferences may be drawn from the facts of this case (i.e., a person would presumably dispose of a cigarette in a wastebasket, rather than next to it), provides a reasonable basis from which the jury finding of proximate cause is supported.

The trial court's granting of judgment to Walgreen is hereby set aside, and the jury's verdict is hereby reinstated in its entirety.

Reversed in part; affirmed in part.

II. Sole Proprietorships and Partnerships

BANK OF AMERICA, N.A. v. CONSTANCE H. BARR

SUPREME JUDICIAL COURT OF MAINE

2010 ME 124; 9 A.3d 816

November 30, 2010, Decided

DISPOSITION: Judgment affirmed.

JUDGES: ALEXANDER, LEVY, MEAD, GORMAN, and JABAR, JJ.

OPINION BY: ALEXANDER, J.

Constance H. Barr appeals from a judgment entered in the Superior Court (Cumberland County, *Wheeler, J.*) following a non-jury trial in which Barr was found to be personally liable for debt incurred on a small business line of credit. . . . We affirm the judgment.

I. CASE HISTORY

The record, including Barr's admissions presented at trial, supports the following factual findings. In 2004, Barr was the 100% owner of The Stone Scone, a business operating as a sole proprietorship. On January 7, 2004, Fleet Bank approved a $100,000 unsecured small business line of credit for The Stone Scone, conditioned upon receipt of a properly signed and witnessed authorization/personal guaranty.

Acting on behalf of The Stone Scone, Barr executed and delivered to Fleet Bank a properly signed and witnessed authorization agreement/personal guaranty portion of the Fleet Bank small business services credit application, dated January 7, 2004. Fleet Bank created, and had sent, a letter addressed to Barr and The Stone Scone, dated January 12, 2004, which stated, "Dear Constance H Barr[:] Congratulations! Your company has been approved for a $100000 Small Business Credit Express Line of Credit," and provided certain of the line of credit's terms. Fleet Bank thereafter provided funds to The Stone Scone pursuant to the terms of the line of credit.

Fleet Bank merged with Bank of America (BoA) in 2004. From February 2004 through November 2008, Fleet Bank, then BoA, sent account statements monthly, addressed to both Barr and The Stone Scone. The monthly statements show that advances were regularly made against, and payments were made to, The Stone Scone line of credit account throughout this period, and also indicate the applicable interest rate and fees.

Two years after the line of credit was approved, The Stone Scone filed articles of organization with the State, registering itself as a limited liability company (LLC) and naming Barr as the manager. BoA was not notified of the change in The Stone Scone's status. Had BoA been informed that The Stone Scone had organized as an LLC, it would have asked for documentation and a new line of credit agreement under the entity's name.

The last payment made to the line of credit account was on October 28, 2008. That payment was "reversed" the same day. As of the last monthly statement, the principal owed on the account was $91,444.09.

On November 4, 2008, BoA sent a past due notice addressed to Barr and The Stone Scone. No payments were made on the account thereafter. Barr admitted that, pursuant to the terms of the line of credit, interest on the unpaid principal balance continued to accrue at a rate of 6.5% per annum.

In March 2009, BoA filed a complaint against Barr and The Stone Scone in the District Court. Barr removed the action to the Superior Court. . . . The only issue for trial was Barr's personal responsibility for the debt. . . .

The BoA's witness was a client manager for BoA, managing the relationship between the Bank and corporate and sole proprietorship clients throughout Maine. He testified that in his position he had access to small business lines of credit client accounts, including The Stone Scone's, and he regularly accessed such information in his position. He had worked for BoA and predecessor banks, including Fleet Bank, for fifteen years. . . . The witness testified that Fleet Bank kept records relating to lines of credit opened for bank clients, and that those records are now maintained by BoA. . . .

The court found that "there is no dispute that there was a contract between Stone Scone and [BoA], [so] the only issue is whether Barr individually is also liable on said contract." Concluding that The Stone Scone and Barr have always been one and the same as far as the Bank was concerned, the court entered judgment in favor of BoA against Barr, individually, and against The Stone Scone, in the amount of $91,444.09 plus interest. Barr, in her individual capacity, then brought this appeal.

II. LEGAL ANALYSIS

A. Admissibility of Evidence

[deleted]

B. Sufficiency of the Evidence

Barr contends that the court erred in finding her personally in breach of the contract because BoA did not present sufficient evidence to support factual findings that (1) a contract was created between Fleet Bank/BoA and Barr, or what the terms or conditions of such a contract were, and (2) Barr is personally liable for the outstanding balance on the line of credit.

Unlike many debt collection cases that come before us, this commercial matter was not resolved by summary judgment, but was the subject of a full trial at which Barr had every opportunity to contest the evidence presented. Thus, on review, we ask not whether there are disputes as to material facts, but whether, assuming that facts were disputed, the trial court's findings regarding the existence of a binding contract and a breach of that contract are supported by sufficient evidence in the record.

"A contract exists if the parties mutually assent to be bound by all its material terms, the assent is either expressly or impliedly manifested in the contract, and the contract is sufficiently definite to enable the court to ascertain its exact meaning and fix exactly the legal liabilities of each party." *Sullivan v. Porter*, 2004 ME 134, P13, 861 A.2d 625, 631.

The trial court found, and Barr does not dispute, that The Stone Scone contracted with Fleet Bank, now BoA, for a small business line of credit. Although the line of credit application is not included in the record in its entirety, the record evidence—specifically, Barr's admissions (which refer to a portion of the line of credit application signed by Barr on behalf of The Stone Scone), the welcome/approval letter, the monthly statements, the four-year course of dealings before the default, the notice of default, and trial testimony—supports the court's determination that a contract existed, that the contract had sufficiently definite terms to enable a court to assign legal liabilities, and that there was sufficient evidence of breach.

The trial record also contains sufficient evidence that Barr is personally liable for the debt owed to BoA. The evidence demonstrates that, at the time Barr acted on The Stone Scone's behalf to procure the small business line of credit, she was the owner of The Stone Scone and the sole proprietor of that business. *See Recalde v. ITT Hartford*, 254 Va. 501 (Va. 1997) (stating that a sole proprietorship is a "form of business in which one person owns all the assets of the business in contrast to a partnership, trust or corporation").

An individual doing business as a sole proprietor, even when business is done under a different name, remains personally liable for all of the obligations of the sole proprietorship.

As the sole proprietor of The Stone Scone when that sole proprietorship entered into the agreement for a line of credit with Fleet Bank, Barr became personally liable for the debts incurred on that line of credit account. The fact that The Stone Scone subsequently converted to an LLC, a fact of which Fleet Bank/BoA was not made aware, does not alter Barr's individual liability in this regard. *See C & J Builders & Remodelers, LLC v. Geisenheimer*, 249 Conn. 415, 733 A.2d 193, 197 (Conn. 1999) (holding that, "where a sole proprietorship converts to a limited liability company," not only are the obligations incurred by the sole proprietorship transferred to the limited liability company, but "the sole proprietor retains personal liability for all preconversion debts and obligations incurred by the sole proprietorship"). To hold otherwise would fail to protect the interests and expectations of third parties in commercial transactions who contracted with the converting sole proprietorship prior to conversion.

The entry is:

Judgment affirmed.

GEORGE VERNON et al., Appellees, v. JERRY SCHUSTER, d/b/a Diversey Heating and Plumbing, Appellant.

SUPREME COURT OF ILLINOIS

179 Ill. 2d 338; 688 N.E.2d 1172

December 18, 1997, Opinion Filed

JUSTICE BILANDIC, dissenting, JUSTICES MILLER and McMORROW join in this dissent.

CHIEF JUSTICE FREEMAN delivered the opinion of the court:

Plaintiffs, George Vernon and Nancy Baker, brought an action in the circuit court of Cook County against defendant, Jerry Schuster, doing business as Diversey Heating and Plumbing. Plaintiffs alleged that defendant, a sole proprietorship, succeeded to the liability of a predecessor sole proprietorship for breach of contract and breach of warranty claims.

The circuit court dismissed those claims for failure to state a cause of action. The appellate court reversed and remanded. We allowed defendant's petition for leave to appeal. We now reverse the appellate court and remand the cause to the circuit court for further proceedings.

BACKGROUND

Plaintiffs contracted with Diversey Heating to replace the boiler in their building. Diversey Heating warranted for 10 years portions of the boiler against cracking. In the course of installing the boiler, Diversey Heating employees sealed a valve with a pipe, which prevented the valve from draining water from the boiler. Diversey Heating instructed Baker that the only care the boiler would need was an annual preseason servicing prior to the heating season. From 1990 through 1992, plaintiffs paid Diversey Heating to inspect and service the boiler annually. In September 1993, Baker and James Schuster agreed that Diversey Heating would perform preseason service on the boiler.

On October 20, 1993, James Schuster died. Beginning on that date, Diversey Heating was a sole proprietorship owned and operated by defendant, Jerry Schuster, who is James Schuster's son.

In late October or early November 1993, Vernon asked Diversey Heating whether it had performed the preseason service on the boiler. Defendant informed Vernon of his father's death. Defendant told Vernon that Diversey Heating had not yet performed the preseason service on the boiler, but that it would service the boiler immediately.

In February 1994, the boiler stopped heating. Defendant inspected the boiler and told plaintiffs that it was totally broken, could not be repaired, and had to be replaced. Defendant told plaintiffs that Diversey Heating had no responsibility for the failure of the boiler and would not honor the warranty. After consulting a second heating contractor, plaintiffs paid $8,203 for a new boiler.

Plaintiffs' complaint alleged that defendant was negligent in installing and servicing the boiler and instructing plaintiffs on caring for the boiler; that Diversey Heating breached its warranty on the boiler, and that Diversey Heating breached its contract to install and service the boiler properly. In these counts, plaintiffs alleged:

> "18. On Jim Schuster's death Jerry Schuster succeeded to the assets, rights and obligations of Diversey Heating and Plumbing and received the benefits of the good will associated with the name of Diversey Heating and Plumbing.
>
> 19. Jerry Schuster d/b/a Diversey Heating and Plumbing is a continuation of Jim Schuster d/b/a Diversey Heating and Plumbing and a successor to the relationship, rights and obligations of Diversey Heating and Plumbing under the contract and warranty."

On defendant's motion, the circuit court dismissed "because this defendant cannot be held liable for any obligations of his father's sole proprietorship."

Plaintiffs appealed from the dismissal. The appellate court reversed and remanded. The court noted the above-quoted allegations that Diversey Heating, a sole proprietorship owned and operated by defendant, was merely a continuation of Diversey Heating, a sole proprietorship owned and operated by his father, James Schuster. . . .

DISCUSSION

The issue presented here is whether plaintiffs sufficiently alleged that defendant succeeded to the liability of his father, James Schuster, doing business as Diversey Heating. The well-settled general rule is that a corporation that purchases the assets of another corporation is not liable for the debts or liabilities of the transferor corporation. . . .

There are exceptions to the general rule of successor corporate nonliability: (1) where there is an express or implied agreement of assumption; (2) [deleted]; or (3) where the purchaser is merely a continuation of the seller, and where the transaction is for the fraudulent purpose of escaping liability for the seller's obligations. These exceptions are recognized in most American jurisdictions. . . . Relying on the third exception, plaintiffs alleged that Diversey Heating, the sole proprietorship of defendant, was the mere continuation of his father's sole proprietorship.

The continuation exception to the rule of successor corporate nonliability applies when the purchasing corporation is merely a continuation or reincarnation of the selling corporation. In other words, the purchasing corporation maintains the same or similar management and ownership, but merely "wears different clothes."

Although purporting to apply the continuation exception to this case, the appellate court did not accurately state the test of continuation. In determining whether one corporation is a continuation of another, the test used in the majority of jurisdictions is whether there is a continuation of the *corporate entity of the seller*—not whether there is a continuation of the *seller's business operation*. . . . .

We note that . . . , our appellate court applied this reasoning in concluding that a sole proprietorship which bought the business and assets of a partnership was not liable as a continuation of the partnership. The partnership's trade name remained on equipment acquired by the sole proprietorship. However, both the partnership and the sole proprietorship "retained their separate identities," and none of the partners "had any interest in the management" of the sole proprietorship.

Common identity of ownership is lacking when one sole proprietorship succeeds another. It is well settled that a sole proprietorship has no legal identity separate from that of the individual who owns it. The sole proprietor may do business under a fictitious name if he or she chooses. However, doing business under another name does not create an entity distinct from the person operating the business. The individual who does business as a sole proprietor under one or several names remains one person, personally liable for all his or her obligations. . . . Thus, one commentator has stated: "There is generally no continuity of existence because on the death of the proprietor, the proprietorship obviously ends."

In this case, "Diversey Heating" has no legal existence. Diversey Heating was only a pseudonym for James Schuster. Once he died, Diversey Heating ceased to exist. Now, Diversey Heating is only a pseudonym for defendant.

Based on the obvious lack of common identity of ownership, the continuation exception to the rule of successor corporate nonliability cannot be applied to defendant. Plaintiffs alleged that James Schuster was the sole proprietor of Diversey Heating until his death and, after which, defendant became the sole proprietor of Diversey Heating. Plaintiffs did *not* allege that defendant held any type of ownership interest in James Schuster's sole proprietorship. Indeed, by definition, defendant could not. Plaintiffs did not allege the existence of any business entity that could survive the death of James Schuster.

Once sole proprietor James Schuster died, he could not be the same sole proprietor as defendant, who became a sole proprietor after his father's death. James Schuster and defendant, one succeeding the other, cannot be the same entity. . . . Even if defendant inherited Diversey Heating from his father, defendant would not have continued his father's sole proprietorship, but rather would have started a new sole proprietorship. . . .

We also note that plaintiffs did not allege that defendant falls within any of the other three exceptions to the rule of successor corporate nonliability. Plaintiffs did not allege that James Schuster and defendant agreed that defendant would assume James Schuster's liabilities and obligations. Plaintiffs did not allege and, logically, could not allege, that defendant consolidated or merged with James Schuster. Also, plaintiffs did not allege that James Schuster fraudulently transferred Diversey Heating to defendant to escape liability. We agree with the circuit court that,

under the rule of successor corporate nonliability, defendant is not liable for the obligations of his father's sole proprietorship.

CONCLUSION

For the foregoing reasons, the judgment of the appellate court is reversed, the judgment of the circuit court of Cook County is affirmed, and the cause is remanded to the circuit court for consideration of plaintiffs' remaining claim.

Appellate court reversed; circuit court affirmed; remanded.

JUSTICE BILANDIC, dissenting:

I respectfully dissent. The plaintiffs' complaint alleged that the plaintiffs purchased a boiler from Diversey Heating and Plumbing, a business engaged in the selling, installing and servicing of heating and plumbing systems located in Chicago. At the time of the plaintiffs' purchase, Jim Schuster owned Diversey Heating and his son, defendant Jerry Schuster, worked with him in the business. When Jim died in October 1993, Jerry took over the business. Apparently without interruption, Jerry continued to operate Diversey Heating and Plumbing as a business engaged in the selling, installing and servicing of heating and plumbing systems. Not only did Jerry retain the name of his father's business, he also continued to operate the business out of the same location and apparently continued to service his father's customers. In my view, these alleged facts clearly provide sufficient support for the plaintiffs' allegation that Jerry Schuster d/b/a Diversey Heating and Plumbing was a mere continuation of Jim Schuster d/b/a Diversey Heating and Plumbing.

The majority finds that, as a matter of law, the plaintiffs cannot prove successor liability in this case. The sole reason successor liability is not possible is that Jim Schuster was a sole proprietor. According to the majority, no other fact or circumstance is relevant because the "essential" element of continuity of ownership is absent. I disagree. As the majority notes, the reason for recognizing exceptions to the general rule of nonliability for successor businesses is to "offset the potentially harsh impact" of the rule. Accordingly, those exceptions should be interpreted and applied in a manner that attempts to achieve fairness in a particular situation. . . . In this case, liberally construing the plaintiffs' complaint, I would find that the plaintiffs sufficiently alleged that Jerry Schuster d/b/a Diversey Heating and Plumbing was a mere continuation of Jim Schuster d/b/a/ Diversey Heating and Plumbing. . . .

The plaintiffs should be allowed the opportunity to the true nature of the transfer of the business from Jim to Jerry.

In sum, I believe that the plaintiffs' successor liability counts against the defendant should be permitted to proceed. The plaintiffs' allegations, when viewed in the light most favorable to the plaintiffs, are clearly sufficient to state a cause of action upon which relief can be granted. Dismissal of the plaintiffs' claims was therefore improper. I would affirm the judgment of the appellate court reversing the dismissal.

JUSTICES MILLER and McMORROW join in this dissent.

Paul Eugene Vohland, Defendant-Appellant, V. Norman E. Sweet, Plaintiff-Appellee

Court of Appeals of Indiana, First District

433 N.E.2d 860

April 20, 1982, Filed

JUDGES: Neal, J. Ratliff, P.J. and Robertson, J., concur.

OPINION BY: NEAL

Plaintiff-appellee Norman E. Sweet (Sweet) brought an action for dissolution of an alleged partnership and for an accounting in the Ripley Circuit Court against defendant-appellant Paul Eugene Vohland (Vohland). From a judgment in favor of Sweet in the amount of $58,733, Vohland appeals.

We affirm.

STATEMENT OF THE FACTS

The undisputed facts reveal that Sweet, as a youngster, commenced working in 1956 for Charles Vohland, father of Paul Eugene Vohland, as an hourly employee in a nursery operated by Charles Vohland and known as Clarksburg Dahlia Gardens. Upon the completion of his military service, which was performed from 1958 to 1960, he resumed his former employment. In approximately 1963 Charles Vohland retired, and Vohland commenced what became known as Vohland's Nursery, the business of which was landscape gardening. At that time Sweet's status changed. He was to receive a 20 percent share of the net profit of the enterprise after all of the expenses were paid. Expenses included labor, gasoline, insurance, burlap, nails, insecticide, fertilizer, seed, straw, plants, stock and seedlings, and any other expense. The compensation was paid on an irregular basis. Every week, two weeks, or perhaps even a month, Sweet and Vohland sat down and computed all income that had been received and all expenses that had been incurred since the last settlement. After the expenses had been deducted from the income, Sweet would receive a check for 20 percent of the balance. Occasionally Sweet would receive an advance draw which would be deducted from his next settlement. No Social Security or income tax was withheld from the checks.

No partnership income tax returns were filed. Vohland and his wife, Gwenalda, filed a joint return in which the business of Vohland's Nursery was reported in Vohland's name on Schedule C. Money paid Sweet was listed as a business expense under "Commissions." Also listed on Schedule C were all of the expenses of the nursery, including investment credit and depreciation on trucks, tractors, and machinery. Sweet's tax returns declared that he was a self-employed salesman at Vohland's Nursery. He filed a self-employment Schedule C and listed as income the income received from the nursery; as expenses he listed travel, advertising, phone, conventions, automobile, and trade journals. He further filed a Schedule C-3 for self-employment Social Security for the receipts from the nursery.

Vohland handled all of the finances and books and did most of the sales. He borrowed money from the bank solely in his own name for business purposes, including the purchase of the interests of his brothers and sisters in his father's business, operating expenses, bid bonds, motor vehicles, taxes, and purchases of real estate. Sweet was not involved in those loans. Sweet managed the physical aspects of the nursery and supervised the care of the nursery stock and the performance of the contracts for customers. Vohland was quoted by one customer as saying Sweet was running things and the customer would have to see Sweet about some problem.

Evidence was contradictory in certain respects. The Vohland Nursery was located on approximately 13 acres of land owned by Charles Vohland. Sweet testified that at the commencement of the arrangement with Vohland in 1963, Charles Vohland grew the stock and maintained the inventory, for which he received 25 percent of the gross sales. In the late 1960's, because of age, Charles Vohland could no longer perform. The nursery stock became depleted to nearly nothing, and new arrangements were made. An extensive program was initiated by Sweet and Vohland to replenish and enlarge the inventory of nursery stock; this program continued until February, 1979. The cost of planting and maintaining the nursery stock was assigned to expenses before Sweet received his 20 percent. The nursery stock generally took up to ten years to mature for market. Sweet testified that at the termination of the arrangement there existed $293,665 in inventory which had been purchased with the earnings of the business. Of that amount $284,860 was growing nursery stock. Vohland, on the other hand, testified that the inventory of 1963 was as large as that of 1979,

but the inventory became depleted in 1969. Vohland claimed that as part of his agreement with Charles Vohland he was required to replenish the nursery stock as it was sold, and in addition pay Charles Vohland 25 percent of the net profit from the operation. He contends that the inventory of nursery stock balanced out. However, Vohland conceded on cross-examination that the acquisition and enlargement of the existing inventory of nursery stock was paid for with earnings and, therefore, was financed partly with Sweet's money. He further stated that the consequences of this financial arrangement never entered his mind at the time.

Sweet's testimony, denied by Vohland, disclosed that, in a conversation in the early 1970's regarding the purchase of inventory out of earnings, Vohland promised to take care of Sweet. Vohland acknowledged that Sweet refused to permit his 20 percent to be charged with the cost of a truck unless his name was on the title. Sweet testified that at the outset of the arrangement Vohland told him, "he was going to take . . . . me in and that . . . . I wouldn't have to punch a time clock anymore, that I would be on a commission basis and that I would be, have more of an interest in the business if I had 'an interest in the business.' . . . . He referred to it as a piece of the action." Sweet testified that he intended to enter into a partnership. Vohland asserts that no partnership was intended and that Sweet was merely an employee, working on a commission. There was no contention that Sweet made any contribution to capital, nor did he claim any interest in the real estate, machinery, or motor vehicles. The parties had never discussed losses. . . .

ISSUES

Vohland presents four issues for review:

> I. Was the evidence sufficient to support the finding of the trial court that Sweet had a 20 percent interest in the inventory of the landscaping business?
>
> II. [omitted]
>
> III. [omitted]
>
> IV. Was the evidence sufficient to support the conclusion of law of the trial court that the business relationship of the parties, Vohland and Sweet, was a partnership?

DISCUSSION AND DECISION

Issues I and IV. Existence of partnership

The principal point of disagreement between Sweet and Vohland is whether the arrangement between them created a partnership, or a contract of employment of Sweet by Vohland as a salesman on commission. It therefore becomes necessary to review briefly the principles governing the establishment of partnerships.

It has been said that an accurate and comprehensive definition of a partnership has not been stated; that the lines of demarcation which distinguish a partnership from other joint interests on one hand and from agency on the other, are so fine as to render approximate rather than exhaustive any attempt to define the relationship.

A partnership is defined by Ind. Code 23-4-1-6(1) (Uniform Partnership Act of 1949):

> "A partnership is an association of two or more persons to carry on as co-owners a business for profit."

Ind. Code 23-4-1-7 sets forth the rules for determining the existence of a partnership:

> "In determining whether a partnership exists, these rules shall apply:
>
> (1) [omitted]
>
> (2) Joint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership does not of itself establish a partnership, whether such co-owners do or do not share any profits made by the use of the property.
>
> (3) The sharing of gross returns does not of itself establish a partnership, whether or not the persons sharing them have a joint or common right or interest in any property from which the returns are derived.
>
> (4) The receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner in the business. . . .

Under Ind. Code 23-4-1-7(4), receipt by a person of a share of the profits is *prima facie* evidence that he is a partner in the business. Lack of daily involvement for one partner is not per se indicative of absence of a partnership. A partnership may be formed by the furnishing of skill and labor by others. The contribution of labor and skill by one of the partners may be as great a contribution to the common enterprise as property or money. It is an established common law principle that a partnership can commence only by the voluntary contract of the parties. "To be a partner, one must have an interest with another in the profits of a business, as profits. There must be a voluntary contract to carry on a business with intention of the parties to share the profits as common owners thereof." . . . .

In the analysis of the facts, we are first constrained to observe that should an accrual method of accounting have been employed here, the enhancement of the inventory of nursery stock would have been reflected as profit, a point which Vohland, in effect, concedes. We further note that both parties referred to the 20 percent as "commissions." To us the term "commission," unless defined, does not mean the same thing as a share of the net profits. However, this term, when used by landscape gardeners and not lawyers, should not be restricted to its technical definition. "Commission" was used to refer to Sweet's share of the profits, and the receipt of a share of the profits is *prima facie* evidence of a partnership. Though evidence is conflicting, there is evidence that the payments were not wages, but a share of the profit of a partnership. It can readily be inferred from the evidence most favorable to support the judgment that the parties intended a community of interest in any increment in the value of the capital and in the profit. Absence of contribution to capital is not controlling, and contribution of labor and skill will suffice. There is evidence from which it can be inferred that the parties intended to do the things which amount to the formation of a partnership, regardless of how they may later characterize the relationship. From the evidence the court could find that part of the operating profits of the business, of which Sweet was entitled to 20 percent, were put back into it in the form of inventory of nursery stock. In the authorities cited above it seems the central factor in determining the existence of a partnership is a division of profits.

From all the circumstances we cannot say that the court erred in finding the existence of a partnership. . . .

For the above reasons this cause is affirmed.

Affirmed.

RATLIFF, P.J., and ROBERTSON, J., CONCUR

Daniel Zuckerman et al., Plaintiffs, v. Joseph Antenucci et al., Defendants

Supreme Court of New York, Trial Term, Queens County

124 Misc. 2d 971; 478 N.Y.S.2d 578

July 31, 1984

DISPOSITION: Accordingly, plaintiffs' motion is granted and plaintiffs are entitled to judgment against defendant Joseph Antenucci and Jose Pena in the amount of $4,000,000 as a matter of law.

JUDGE: Sidney Leviss, J.

OPINION OF THE COURT

This is a posttrial motion for judgment against defendants Joseph Antenucci and Jose Pena, in the sum of $4,000,000.

Daniel Zuckerman, an infant, by his mother and natural guardian, Elaine Zuckerman, and Elaine Zuckerman, individually, brought a medical malpractice action against Dr. Joseph Antenucci and Dr. Jose Pena. Both had treated the mother during pregnancy. Although the summons did not state that the two defendants were partners, the undisputed, unopposed and uncontradicted evidence at the trial established that relationship, and that the alleged acts of malpractice were done in the course of partnership business. The jury returned a verdict finding that defendant Pena was guilty of malpractice, but defendant Antenucci was not guilty of malpractice. The amount of the verdict totaled $4,000,000.

The issue is whether this court has jurisdiction to render a judgment against defendant Antenucci on the basis of a tort committed by his partner, even though the summons served did not designate defendant Antenucci as a partner. Defendant Antenucci relies upon *Jet Age Knitwear Mach. Corp. v Philip* (22 AD2d 674), where the Appellate Division held that the description in the caption and complaint of a defendant as doing business under the name of a partnership was not sufficient to confer jurisdiction over the partnership as an entity. *Connell v Hayden* (83 AD2d 30), a medical malpractice case decided by the Appellate Division is also noteworthy. There, the court held that in the absence of an apparent misdescription or misnomer on the process, "a summons which named and which was served only upon an individual could not be amended so as to substitute an unnamed corporation through which the named party conducted his business". The court found that the summons served on the individual was insufficient to confer jurisdiction over the professional corporation through which he conducted business. . . . .

A party may be sued individually and directly for the tort of his partner. (See *Caplan v Caplan*, 268 NY 445; Beane, Essentials of Partnership Law, p 62.) A partnership is liable for the tortious act of a partner, and a partner is jointly and severally liable for tortious acts chargeable to the partnership. (Partnership Law, §§ 24, 26.)

"Thus, if a partner, while acting in the course of the partnership business injures a third person, such third person would have the right to sue all of the partners together in one lawsuit, or any one or all of the partners individually, including even one who did not cause the injury". (Beane, Essentials of Partnership Law, p 63.)

"If it is a joint and several obligation of the partnership (based on a tort), any one (or some or all) of the individual partners may be sued personally *without suing the partnership itself*". (Beane, Essentials of Partnership Law, p 62; emphasis added.)

"When a tort is committed by the firm, the wrong is imputable to all of the partners jointly and severally, and an action may be brought against all or any of them in their individual capacities * * * or against the partnership **as an entity**". (*Pedersen v Manitowoc Co*., 25 NY2d 412, 419.)

To illustrate how a plaintiff may proceed where a tort is chargeable to a partnership, Professor Beane supposes a partnership, the ABC Shoe Store, composed of Able, Baker, and Charles. A customer, Mrs. Jones, who is injured by Kit, an employee of the partnership, may elect to sue in several different ways: "For example, Mrs. Jones may commence an action listing as defendants: 'Able, Baker, and Charles individually and as partners, doing business under the name of ABC Shoe Store'; or she could commence an action listing 'ABC Shoe Store' as the defendant; or she could sue any of the individual partners directly (without naming the partnership) as they are each jointly and severally liable for the tort. Therefore, she could commence an action against 'Able' or she could commence an action against 'Able and

Baker', or against 'Able and Charles', or 'Baker and Charles'. Since a person is liable for one's own tort, Mrs. Jones could also sue Kit, the employee; Kit could be named as a defendant in any of the preceding suggested actions." (Beane, Essentials of Partnership Law, p 63.)

It may thus be seen that the plaintiffs herein did not have to sue a partnership entity and did not have to write "Joseph Antenucci, a partner" on the summons in order to hold him liable on a partnership theory for the act of defendant Pena. Jurisdiction over defendant Antenucci individually is sufficient for a judgment against him based on a tort committed by his partner.

Therefore, even though the jury found that defendant Antenucci was not guilty of any malpractice in his treatment of the patient, but that defendant Pena (his partner) was guilty of malpractice in his treatment of the patient, they were then both jointly and severally liable for the malpractice committed by defendant Pena by operation of law.

Accordingly, plaintiffs' motion is granted and plaintiffs are entitled to judgment against defendant Joseph Antenucci and Jose Pena in the amount of $4,000,000 as a matter of law.

Frigidaire Sales Corporation, Petitioner, v. Union Properties, Inc., et al, Respondents

Supreme Court of Washington

562 P.2d 244 (1977)

April 7, 1977

JUDGES: En Banc.

OPINION BY: Judge Hamilton

Petitioner, Frigidaire Sales Corporation, sought review of a Court of Appeals decision which held that limited partners do not incur general liability for the limited partnership's obligations simply because they are officers, directors, or shareholders of the corporate general partner. [citations omitted] We granted review, and now affirm the decision of the Court of Appeals.

The facts of the case are adequately set out in the Court of Appeals opinion, and only a cursory summation need be repeated here. Petitioner entered into a contract with Commercial Investors (Commercial), a limited partnership. Respondents, Leonard Mannon and Raleigh Baxter, were limited partners of Commercial. Respondents were also officers, directors, and shareholders of Union Properties, Inc., the only general partner of Commercial. Respondents controlled Union Properties, and through their control of Union Properties they exercised the day-to-day control and management of Commercial. Commercial breached the contract, and petitioner brought suit against Union Properties and respondents. The trial court concluded that respondents did not incur general liability for Commercial's obligations by reason of their control of Commercial, and the Court of Appeals affirmed.

We first note that petitioner does not contend that respondents acted improperly by setting up the limited partnership with a corporation as the sole general partner. Limited partnerships are a statutory form of business organization, and parties creating a limited partnership must follow the statutory requirements. In Washington, parties may form a limited partnership with a corporation as the sole general partner. *See* RCW 25.04.020 and RCW 25.04.060(3); RCW 25.08.010 and RCW 25.08.070(2)(a).

Petitioner's sole contention is that respondents should incur general liability for the limited partnership's obligations under RCW 25.08.070, [1] because they exercised the day-to-day control and management of Commercial. Respondents, on the other hand, argue that Commercial was controlled by Union Properties, a separate legal entity, and not by respondents in their individual capacities.

Petitioner cites *Delaney v. Fidelity Lease Ltd.*, 526 S.W.2d 543 (Tex. 1975), as support for its contention that respondents should incur general liability under RCW 25.08.070 for the limited partnership's obligations. That case also involved the issue of liability for limited partners who controlled the limited partnership as officers, directors, and shareholders of the corporate general partner. The Texas Supreme Court reversed the decision of the Texas Court of Civil Appeals and found the limited partners had incurred general liability because of their control of the limited partnership. [citations omitted]

We find the Texas Supreme Court's decision distinguishable from the present case. In *Delaney*, the corporation and the limited partnership were set up contemporaneously, and the sole purpose of the corporation was to operate the limited partnership. The Texas Supreme Court found that the limited partners who controlled the corporation were obligated to their other limited partners to operate the corporation for the benefit of the partnership. "'Each act was done then, not for the corporation, but for the partnership.'" [citations omitted] This is not the case here. The pattern of operation of Union Properties was to investigate and conceive of real estate investment opportunities and, when it found such opportunities, to cause the creation of limited partnerships with Union Properties acting as the general partner. Commercial was only one of several limited partnerships so conceived and created. Respondents did not form Union Properties for the sole purpose of operating Commercial. Hence, their acts on behalf of Union Properties were not performed merely for the benefit of Commercial.

Further, it is apparently still undecided in Texas whether parties may form a limited partnership with a corporation as the sole general partner. The Texas Supreme Court was concerned with the possibility that limited partners might form the corporate general partner with minimum capitalization:

> In no event should they be permitted to escape the statutory liability which would have devolved upon them if there had been no attempted interposition of the corporate shield against personal liability. Otherwise, the statutory requirement of at least one general partner with general liability in a limited partnership can be circumvented or vitiated by limited partners operating the partnership through a corporation with minimum capitalization and therefore minimum liability.

However, we agree with our Court of Appeals analysis that this concern with minimum capitalization is not peculiar to limited partnerships with corporate general partners, but may arise anytime a creditor deals with a corporation. [citations omitted] Because our limited partnership statutes permit parties to form a limited partnership with a corporation as the sole general partner, this concern about minimal capitalization, standing by itself, does not justify a finding that the limited partners incur general liability for their control of the corporate general partner. [citations omitted] If a corporate general partner is inadequately capitalized, the rights of a creditor are adequately protected under the "piercing-the-corporate-veil" doctrine of corporation law. [citations omitted]

Furthermore, petitioner was never led to believe that respondents were acting in any capacity other than in their corporate capacities. The parties stipulated at the trial that respondents never acted in any direct, personal capacity. When the shareholders of a corporation, who are also the corporation's officers and directors, conscientiously keep the affairs of the corporation separate from their personal affairs, and no fraud or manifest injustice is perpetrated upon third persons who deal with the corporation, the corporation's separate entity should be respected. . . .

For us to find that respondents incurred general liability for the limited partnership's obligations under RCW 25.08.070 would require us to apply a literal interpretation of the statute and totally ignore the corporate entity of Union Properties, when petitioner knew it was dealing with that corporate entity. There can be no doubt that respondents, in fact, controlled the corporation. However, they did so only in their capacities as agents for their principal, the corporate general partner. Although the corporation was a separate entity, it could act only through its board of directors, officers, and agents. [citations omitted] Petitioner entered into the contract with Commercial. Respondents signed the contract in their capacities as president and secretary-treasurer of Union Properties, the general partner of Commercial. In the eyes of the law it was Union Properties, as a separate corporate entity, which entered into the contract with petitioner and controlled the limited partnership.

Further, because respondents scrupulously separated their actions on behalf of the corporation from their personal actions, petitioner never mistakenly assumed that respondents were general partners with general liability. [citations omitted] Petitioner knew Union Properties was the sole general partner and did not rely on respondents' control by assuming that they were also general partners. If petitioner had not wished to rely on the solvency of Union Properties as the only general partner, it could have insisted that respondents personally guarantee contractual performance. Because petitioner entered into the contract knowing that Union Properties was the only party with general liability, and because in the eyes of the law it was Union Properties, a separate entity, which controlled the limited partnership, there is no reason for us to find that respondents incurred general liability for their acts done as officers of the corporate general partner.

The decision of the Court of Appeals is affirmed.

Note 1: RCW 25.08.070 read as follows:

> A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as limited partner, he takes part in the control of the business. Laws of 1955, ch. 15, § 25.08.070, p. 140.

In 1972, the legislature amended RCW 25.08.070 by adding two additional sections. Laws of 1972, 1st Ex. Sess., ch. 113, § 2, p. 253. RCW 25.08.070 presently reads:

> (1) A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as limited partner, he takes part in the control of the business.
>
> (2) A limited partner shall not be deemed to take part in the control of the business by virtue of his possessing or exercising a power, specified in the certificate, to vote upon matters affecting the basic structure of the partnership. . .

Ruthiran Siva, Plaintiff-Appellant, v. 1138 LLC et al., Defendants-Appellees.

Court of Appeals of Ohio, Tenth Appellate District, Franklin County

2007 Ohio 4667; 2007 Ohio App. LEXIS 4202

September 11, 2007, Rendered

JUDGES: BROWN, J. SADLER, P.J., and TYACK, J., concur.

OPINION BY: BROWN

This is an appeal by plaintiff-appellant, Ruthiran Siva, from a judgment of the Franklin County Court of Common Pleas, finding in favor of defendant-appellee, Richard Hess ("Hess"), on appellant's claim that Hess was personally liable for damages arising from the breach of a lease agreement entered between appellant and a limited liability company.

Appellant is the owner of a commercial premises located at 1138 Bethel Road. Defendant-appellee, 1138 LLC (hereafter "1138 LLC"), is a limited liability corporation, formed under Ohio law in 2004, and comprised of five members: Hess, defendant-appellee Robert E. Haines, Lisa Hess, Nathan Hess, and Zack Shahin. On October 29, 2004, appellant and 1138 LLC entered into a written lease agreement, whereby 1138 LLC leased from appellant the Bethel Road premises for a term of five years, commencing on December 1, 2004, at a monthly rental amount of $ 4,000. Shortly thereafter, 1138 LLC began operating a bar on the premises.

On July 22, 2005, appellant filed a complaint, naming as defendants 1138 LLC, Hess, Robert E. Haines (individually "Haines"), and Haines' wife, Helen C. Haines. Under Count 1 of the complaint, appellant alleged that 1138 LLC was in default and breach of the lease agreement, while under Count 2 appellant sought to pierce the corporate veil to hold both Haines and Hess personally liable for the debts of the company.

On September 2, 2005, Haines and his wife filed an answer and counterclaim. On September 30, 2005, appellant filed a motion to dismiss the counterclaim. The trial court subsequently granted default judgment against Haines, and also granted appellant's motion to dismiss the counterclaim of Haines and his wife. On October 3, 2005, appellant filed a motion for default judgment against 1138 LLC as to the issue of liability. By entry filed October 7, 2005, the trial court granted appellant's motion for default judgment against 1138 LLC.

The matter came for hearing before the trial court on August 9, 2006, on the issue of individual liability as to Hess. By decision and entry filed August 28, 2006, the trial court found in favor of Hess on appellant's complaint, concluding that the evidence was insufficient to show Hess was the "alter ego" of 1138 LLC, or that he exerted the requisite degree of control over the business to hold him individually liable for the debt of the company.
On appeal, appellant sets forth the following assignment of error for this court's review:

> The Common Pleas Court's Decision and Judgment in favor of Defendant/Appellee, was against the manifest weight of the evidence.

Under his single assignment of error, appellant contends that the trial court's decision finding in favor of Hess was against the manifest weight of the evidence. Appellant maintains there was sufficient evidence presented to establish all of the elements necessary . . . to hold Hess personally liable for the debts of 1138 LLC.

It is well-settled that "[j]udgments supported by some competent, credible evidence going to all the essential elements of the case will not be reversed by a reviewing court as being against the manifest weight of the evidence." *C.E. Morris Co. v. Foley Constr. Co.* (1978), 54 Ohio St.2d 279. In considering whether a judgment is against the manifest weight of the evidence, an appellate court is "guided by a presumption that the findings of the trier-of-fact were indeed correct." *Seasons Coal Co. v. Cleveland* (1984), 10 Ohio St.3d 77. The rationale for this presumption, affording deference to the findings of the trial court, "rests with the knowledge that the trial judge is best able to view the witnesses and observe their demeanor, gestures and voice inflections, and use these observations in weighing the credibility of the proffered testimony." Id.

In the present case, the trial court's analysis was based upon its assumption that the doctrine of "piercing the corporate veil" was applicable to limited liability corporations, and the court therefore considered the three-part test for piercing the corporate veil as set forth by the Ohio Supreme Court in *Belvedere,* supra. In *Belvedere,* the court described that test as follows:

> [T]he corporate form may be disregarded and individual shareholders held liable for corporate misdeeds when (1) control over the corporation by those to be held liable was so complete that the corporation has no separate mind, will, or existence of its own, (2) control over the corporation by those to be held liable was exercised in such a manner as to commit fraud or an illegal act against the person seeking to disregard the corporate entity, and (3) injury or unjust loss resulted to the plaintiff from such control and wrong.

The first prong of *Belvedere* has been referred to as the "alter ego doctrine," and, in order to succeed under this prong, "a plaintiff must show that the individual and the corporation are fundamentally indistinguishable." Id., at 288. Some non-exhaustive factors to be considered in determining whether this prong has been met include grossly inadequate capitalization, the failure to observe corporate formalities, the diversion of funds or other property of the company for personal use, and the absence of corporate records. In considering the second prong of *Belvedere,* the party seeking to pierce the corporate veil "must establish that 'the shareholder exercised the control established under the first prong of the test to commit fraud or other wrongful conduct.' " Id., at P38. In addition to fraud, Ohio courts have found the second prong to be satisfied "when 'unjust or inequitable' consequences occur." Id.

Courts have held that whether the three-part test of *Belvedere* has been satisfied is primarily for the trier of fact to determine, and a reviewing court will examine the record "for competent, credible evidence to support the decision of the trial court."

We note, at the outset, an alternative argument urged by Hess in support of affirming the trial court's judgment. Specifically, Hess acknowledges that the trial court rejected his argument that a limited liability company is not governed by common-law principles creating a right to pierce the corporate veil; nevertheless, Hess reiterates the contention he made before the trial court that the legislature did not intend personal liability against a limited liability company except under very limited circumstances. Hess, however, did not cross appeal the trial court's determination that the concept of piercing the corporate veil was presumptively applicable to limited liability corporations, and, thus, has failed to preserve for appeal that argument. Thus, the issue before this court on appeal is whether the trial court's application of *Belvedere* to the facts of this case was against the manifest weight of the evidence adduced at trial.

Regarding the first prong of *Belvedere,* appellant contends that the evidence regarding 1138 LLC demonstrates undercapitalization, lack of adequate business records, and the commingling of funds. Appellant maintains that Hess had the ultimate discretion over 1138 LLC, and that he ignored the formalities normally associated with a limited liability company. As to the second and third prongs of *Belvedere,* appellant contends that Hess had no idea what happened to the assets of 1138 LLC and that, because the limited liability corporation was nothing more than a shell, appellant had nowhere to look to collect unpaid rent and other amounts due as a result of the breach.

In applying the test set forth in *Belvedere,* supra, the trial court found that appellant had not met his burden of proof that Hess was the alter ego of 1138 LLC, or that Hess exerted the requisite degree of control over the business to justify piercing the corporate veil. Rather, the trial court found credible testimony that Haines exerted much of the control over the operation of the business, and that the manner in which Haines exercised that control caused Hess to verbally agree to relinquish his interest in the business in March 2005.

Based upon this court's examination of the record, we find there was competent, credible evidence to support the trial court's determination. At trial, much of the evidence regarding the formation and operation of 1138 LLC came from the testimony of Hess, who related that the members of 1138 LLC held an initial meeting to determine how the company would be run. As noted under the facts, the company opened a bar, "Sherlocks," on the rental premises. At the time of the formation of 1138 LLC, Nathan Hess, who was to manage the bar, contributed $ 4,000 to start the business, while members Haines and Shahin were to contribute the balance. Hess testified that Shahin's contribution was approximately $ 25,000; Haines, however, failed to contribute his full share at the outset, and, according to Hess, this became "a problem right off the get go." (Tr. at 20.)

At about the time of the formation of 1138 LLC, Hess was also involved in the formation of another limited liability company, the Easton Wine Gallery ("Wine Gallery"), a retail wine business. Shahin and Nathan Hess were also

members of that company. Hess testified that Rich Ratterman and Lisa Hess controlled the day-to-day operations of the Wine Gallery. Hess wrote checks to both 1138 LLC and the Wine Gallery, but Hess testified that 1138 LLC had its own separate checking account.

Upon review, the record contains evidence to support the trial court's finding that Haines exercised significant control over 1138 LLC, ultimately forcing Hess out of the bar venture. According to Hess, while Haines' role was initially intended to be limited to that of investor, he became involved from the outset in the bar's day-to-day operations. Hess stated that problems arose with Haines shortly after Sherlocks opened around December 2004; Haines, who was authorized to make purchases on behalf of 1138 LLC, was at one point taken off the checking account because, according to Hess, "he took money out of the account." (Tr. at 31.) Further, the fact that Haines "had not put in the amount of money that he was supposed to have put in" contributed to an acrimonious relationship between Hess and Haines. (Tr. at 32.)

An attorney subsequently advised Hess "to either buy him [Haines] out or have him buy you out." (Tr. at 33.) As a result of these developments, and after approximately just three months of operation, Hess, along with Nathan Hess, Shahin and Lisa Hess, reached an oral agreement with Haines to turn over all the operations of the bar to him in March 2005. That agreement was later memorialized in a written document, signed by the parties on June 2, 2005, and Hess testified that he had no involvement in the operation of the bar after early March 2005. Here, there was evidence upon which the trial court could have concluded that Hess did not exercise the type of absolute, complete authority necessary to satisfy the first prong of *Belvedere.*

Even assuming, however, that the evidence was sufficient to show control on the part of Hess necessary to satisfy the first prong of the test, appellant did not present evidence demonstrating that Hess committed a fraud or illegal act against appellant. Although Hess expressed frustration that Haines failed to fulfill his financial commitments to the company, the evidence did not show that Hess purposely undercapitalized 1138 LLC, or that he formed the limited liability company in an effort to avoid paying creditors. Further, while Hess acknowledged writing checks to both 1138 LLC and the Wine Gallery, there was no evidence demonstrating that 1138 LLC had money for rent but that Hess fraudulently transferred funds to the Wine Gallery to avoid paying appellant, nor is there any evidence that Hess diverted funds to himself for the brief time he was involved with the bar. Rather, the evidence indicated that the primary reason for non-payment of rent was due to lack of revenue. According to Hess, the bar was never profitable, and, at the time he turned over operations to Haines in March 2005, 1138 LLC was behind in rent, "but it was paid up probably within a week after I got out." (Tr. at 49.) Based upon the evidence presented, a reasonable trier of fact could have concluded that 1138 LLC became insolvent due to unprofitable operations. Moreover, even if the record suggests poor business judgment by Hess, it does not demonstrate that he formed 1138 LLC to defraud its creditors.

Finally, the evidence did not show that appellant was misguided as to the fact he was dealing with a limited liability company. Appellant's counsel drafted the lease agreement, and appellant acknowledged at trial he did not ask any of the owners of 1138 LLC to sign the lease in an individual capacity. Significantly, appellant himself testified that he had no reason to believe Hess personally committed fraud against him.

A corporation's breach of contract, standing alone, is insufficient to satisfy the second prong of the *Belvedere* test. Rather, a party who suffers loss from a corporation's breach ordinarily has recourse against the corporation and its assets or guarantors, if any. In the instant case, appellant obtained default judgments against 1138 LLC and Haines. Appellant, however, has not demonstrated extraordinary circumstances to justify holding Hess personally liable. Accordingly, we conclude that the decision of the trial court, finding that appellant did not satisfy the elements of *Belvedere,* is not against the manifest weight of the evidence.

Based upon the foregoing, appellant's single assignment of error is overruled, and the judgment of the Franklin County Court of Common Pleas is hereby affirmed.

Judgment affirmed.

SADLER, P.J., and TYACK, J., concur.

III. Corporations

COOPERS & LYBRAND, Plaintiff-Appellant, v. Garry J. FOX, Defendant-Appellee

Court of Appeals of Colorado, Division Four

758 P.2d 683 (1988)
May 19, 1988

JUDGES: Chief Judge Kelly. Tursi and Metzger, JJ., concur.

OPINION BY: Chief Judge Kelly

In an action based on breach of express and implied contracts, the plaintiff, Coopers & Lybrand (Coopers), appeals the judgment of the trial court in favor of the defendant, Garry J. Fox (Fox). Coopers contends that the trial court erred in ruling that Fox, a corporate promoter, could not be held liable on a pre-incorporation contract in the absence of an agreement that he would be so liable, and that Coopers had, and failed to sustain, the burden of proving any such agreement. We reverse.

On November 3, 1981, Fox met with a representative of Coopers, a national accounting firm, to request a tax opinion and other accounting services. Fox informed Coopers at this meeting that he was acting on behalf of a corporation he was in the process of forming, G. Fox and Partners, Inc. Coopers accepted the "engagement" with the knowledge that the corporation was not yet in existence.

G. Fox and Partners, Inc., was incorporated on December 4, 1981. Coopers completed its work by mid-December and billed "Mr. Garry R. [sic] Fox, Fox and Partners, Inc." in the amount of $10,827. When neither Fox nor G. Fox and Partners, Inc., paid the bill, Coopers sued Garry Fox, individually, for breach of express and implied contracts based on a theory of promoter liability.

Fox argued at trial that, although Coopers knew the corporation was not in existence when he engaged the firm's services, it either expressly or impliedly agreed to look solely to the corporation for payment. Coopers argued that its client was Garry Fox, not the corporation. The parties stipulated that Coopers had done the work, and Coopers presented uncontroverted testimony that the fee was fair and reasonable.

The trial court failed to make written findings of fact and conclusions of law. However, in its bench findings at the end of trial, the court found that there was no agreement, either express or implied, that would obligate Fox, individually, to pay Coopers' fee, in effect, because Coopers had failed to prove the existence of any such agreement. The court entered judgment in favor of Fox.

I.

As a preliminary matter, we reject Fox's argument that he was acting only as an agent for the future corporation. One cannot act as the agent of a nonexistent principal. [citations omitted]

On the contrary, the uncontroverted facts place Fox squarely within the definition of a promoter. A promoter is one who, alone or with others, undertakes to form a corporation and to procure for it the rights, instrumentalities, and capital to enable it to conduct business. [citations omitted]

When Fox first approached Coopers, he was in the process of forming G. Fox and Partners, Inc. He engaged Coopers' services for the future corporation's benefit. In addition, though not dispositive on the issue of his status as a promoter, Fox became the president, a director, and the principal shareholder of the corporation, which he funded, only nominally, with a $100 contribution. Under these circumstances, Fox cannot deny his role as a promoter.

II.

Coopers asserts that the trial court erred in finding that Fox was under no obligation to pay Coopers' fee in the absence of an agreement that he would be personally liable. We agree.

As a general rule, promoters are personally liable for the contracts they make, though made on behalf of a corporation to be formed. [citations omitted] The well-recognized exception to the general rule of promoter liability is that if the contracting party knows the corporation is not in existence but nevertheless agrees to look solely to the corporation and not to the promoter for payment, then the promoter incurs no personal liability. [citations omitted] In the absence of an express agreement, the existence of an agreement to release the promoter from liability may be shown by circumstances making it reasonably certain that the parties intended to and did enter into the agreement.

Here, the trial court found there was *no* agreement, either express or implied, regarding Fox's liability. Thus, in the absence of an agreement releasing him from liability, Fox is liable.

III.

Coopers also contends that the trial court erred in ruling, in effect, that Coopers had the burden of proving any agreement regarding Fox's personal liability for payment of the fee. We agree.

Release of the promoter depends on the intent of the parties. As the proponent of an alleged agreement to release the promoter from liability, the promoter has the burden of proving the release agreement.

Fox seeks to bring himself within the exception to the general rule of promoter liability. However, as the proponent of the exception, he must bear the burden of proving the existence of the alleged agreement releasing him from liability. The trial court found that there was no agreement regarding Fox's liability. Thus, Fox failed to sustain his burden of proof, and the trial court erred in granting judgment in his favor.

IV.

It is undisputed that the defendant, Garry J. Fox, engaged Coopers' services, that G. Fox and Partners, Inc., was not in existence at that time, that Coopers performed the work, and that the fee was reasonable. The only dispute, as the trial court found, is whether Garry Fox is liable for payment of the fee. We conclude that Fox is liable, as a matter of law, under the doctrine of promoter liability.

Accordingly, the judgment is reversed, and the cause is remanded with directions to enter judgment in favor of Coopers & Lybrand in the amount of $10,827, plus interest to be determined by the trial court.

JUDGE TURSI and JUDGE METZGER concur.

DIANE GERINGER, individually, and as surviving spouse of William Geringer, decedent, and mother of Jared Geringer, decedent, Plaintiff(s), v. WILDHORN RANCH, INC., a Colorado Corporation, M. R. WATTERS and LES BRETZKE, Defendants

United States District Court for The District of Colorado

706 F. Supp. 1442 (1988)

December 14, 1988, Decided

JUDGE: Sherman G. Finesilver, Chief United States District Judge.

This matter comes before the court on motions of defendants for judgment notwithstanding the verdict, for new trial, and for amended judgment. On September 28, 1988, the jury returned a verdict against defendants for damages arising out of a boating accident at the Wildhorn Ranch Resort. The court considered many of the issues raised in defendants' post-trial motions prior to and during trial. We have considered defendants' motions collectively and individually and conclude that neither a new trial, judgment notwithstanding the verdict, nor amended judgment is warranted. The evidence supports the jury's verdict. The several motions are DENIED for the reasons stated below.

I.

Plaintiff Diane Geringer brought this action in her own name and as guardian of her minor-daughter Tara Geringer, pursuant to Colorado law, seeking damages for personal injuries and the wrongful death of her husband William Geringer and minor-son Jared Geringer. Jurisdiction before this court is based on diversity of citizenship.

During August of 1986, the Geringer family was vacationing at the Wildhorn Ranch Resort, a guest ranch located in Teller County, Colorado. William and Jared Geringer drowned during a boating accident on a lake at the Ranch. Paddleboating was among the recreational activities offered by the Resort.

At trial, the liability evidence focused on the maintenance and condition of the paddleboats, operation of the Resort, and plaintiffs' conduct in procuring and operating the boat. Plaintiffs' case focused on repairs made a short time prior to the accident and defendants' knowledge that the boats leaked, filled with water, and became unstable. Defendants' case for comparative or contributory negligence argued that the Geringers took out a boat that had been secured to the shore and acted unreasonably in not wearing life jackets. Plaintiffs' rebuttal raised conflicting evidence as to whether the boats had been secured to discourage their unsupervised use and whether life jackets were available.

Defendant M.R. Watters originally owned the Ranch, but claimed to have deeded it over to Wildhorn Ranch, Inc. Wildhorn Ranch, Inc. operated the Resort and provided management services to the homeowners association time-share cabins. The corporation was owned by the three members of its Board of Directors, M.R. Watters, son David, and wife Doris. . . . M.R. Watters inspected the boats and determined they were fit for return to the water. The boats were repaired by a Resort employee with the assistance of a ranch-hand. The ranch-hand was employed by a firm contracted to operate horseback riding facilities at the Ranch.

Evidence was also presented at trial on the issue of corporate alter-ego. The theory of corporate alter-ego requires plaintiff to show that an individual consistently disregarded the formalities of the corporate form and so dominated the affairs of the corporation, in a manner which injured the plaintiff, that to continue to acknowledge the legal fiction of the corporation would promote injustice and harm public convenience. This evidence was presented through the testimony of M.R. Watters and others involved in the operation of the resort and through the admission of various corporate records. . . .

The jury found that all of the parties had been negligent and that their negligence had caused the plaintiffs' injuries. The jury apportioned the negligence causing the accident. . . . The jury concluded that Wildhorn Ranch, Inc. was the corporate alter-ego of M.R. Watters and charged negligence attributable to the corporation to M.R. Watters. The jury also found that the conduct of each of the defendants was wanton and willful and awarded exemplary damages against each of the defendants.

II. [omitted]

III.

Defendant Watters challenges the verdict finding him liable for the negligence of his alleged corporate alter-ego, Wildhorn Ranch, Inc. By its verdict, the jury found that Wildhorn Ranch, Inc. was the corporate alter-ego of defendant M.R. Watters and that his domination of the corporation caused injury to the plaintiff. The record reflects that there was sufficient evidence to support the jury verdict that M.R. Watters was liable for his own negligence as well as that of the corporation. . . .

Colorado law is consistent with general common law on corporate alter-ego or piercing the corporate veil. [citations omitted] Whether or not adherence to the corporate fiction would promote injustice in a particular case is an equitable issue. [citations omitted] Where the parties to an action with jury triable issues do not agree that an equitable issue should be presented to the jury, the court may substitute its own findings of fact for those of the jury, if necessary. [citations omitted] There is no error in submitting the issue to the jury. [citations omitted] The approach is particularly appropriate in tort cases where causation issues underlay the finding of corporate liability as well as negligence.

The jury was instructed on the law and purposes of the corporate alter-ego doctrine and that defendant Watters could be held liable for the corporation if they found plaintiff had proved three factors: (1) that he has consistently engaged in a course of conduct by which he has ignored the existence of the corporate entity or entities; (2) that he has, in fact, conducted business as an individual by exercising such paramount and personal control over the operations of the corporation that their corporate existence has been disregarded and their business interests and his own personal interests cannot be reasonably separated; and (3) that his domination of the corporation caused injury to the plaintiff so that to continue to recognize the existence of a separate corporate entity would promote injustice. . . .

Plaintiffs presented substantial evidence that defendant Watters disregarded corporate formalities in operating Wildhorn Ranch, Inc. In 1985, Watters regained ownership of the Wildhorn Ranch through foreclosure on its previous owner. Within days of the foreclosure, Watters formed Wildhorn Ranch, Inc. Defendant produced the Articles of Incorporation. Although Watters testified that he had deeded the Ranch over to the corporation, the deed could not be located. Although Watters testified that stock in the corporation had been purchased, and this fact was corroborated by the testimony of David Watters that he had paid $100,000 for his shares, no stock was issued and no record of the transaction was produced.

Once a week, the family held "formal" corporate board meetings at their home in Rocky Ford, Colorado. Watters's wife attended some of these meetings, but Watters could not recall how often. No minutes were produced. Watters could not recall how often minutes were actually taken.

Watters operated several corporations out of his office. Debts of one corporation were frequently paid with funds from another corporation or from Watters's personal funds, depending upon the financial condition of a particular corporation when the debt came due. The bill of sale for the paddleboats in issue and Watters testimony proved that Watters purchased the boats with funds from a corporation unrelated to the Ranch, the Resort, or the homeowners association. . . . Although Watters testified that loans between the corporation were duly entered in the ledgers of each corporation by his secretary, no record of the loans or ledgers was produced. Testimony of the principals and employees regarding their own responsibilities and those of the various corporations and managers working at the Ranch demonstrated that the operation of the corporation was so muddled that no clear picture of accountability or organization can be drawn from the record.

While no one factor controls our analysis, the court must view the record as a whole to determine whether the corporate form has been used to defeat the public convenience. . . . . The clear import of the entire record is that Watters consistently engaged in a course by which he ignored the existence of Wildhorn Ranch, Inc. and his other corporations.

Defendant Watters's domination and control of the corporation was reflected in the testimony of various employees of the Ranch. Testimony supported the perception of various employees that Watters was in complete control of the Ranch. For example, Watters testified that he could fire all of its employees or "clean house" if he found it necessary. Watters presented the sheriff's deputy investigating the accident with a business card which represented that Watters was the owner of Wildhorn Ranch, Inc. . . . Again, while the factors of note in the record may seem ambiguous when

viewed in isolation, the record as a whole clearly establishes the fact that Watters was in control of Wildhorn Ranch, Inc., its board of directors, and employees.

Similarly, the issue of whether Watters' domination of the company caused injury to the plaintiff was addressed through the testimony of Watters and the employees who repaired the boat. The jury found that Watters personally had acted negligently and that his negligence caused injury to the plaintiffs. According to this testimony (1) Watters purchased the boats for the Wildhorn Ranch, Inc. using funds from another corporation, (2) in taking this action for the corporation, Watters selected certain boats from a number of others he admitted were in disrepair, (3) Watters had knowledge that the boats leaked, became unstable, and required frequent removal from the lake to drain water from their hulls, (4) Watters inspected the boats after leaks had been patched and determined that the extra repairs requested by his employees were cosmetic, unnecessary, and costly, (5) Watters decided that the boats should be returned to the water for use, (6) over the objections of the employees who had been making the repairs, the boats were returned to the water.

Defendant Watters's control of the finances, facilities and employees of the Wildhorn Ranch Resort, of Wildhorn Ranch, Inc. and of other corporations caused the injuries of which plaintiffs complain. To allow Watters to assert the fiction of a separate corporate entity as a means of avoiding liability when he has consistently disregarded the corporate form would defeat public convenience.

IV. [omitted]

V.

We have considered the totality of the evidence regarding the corporate form of Wildhorn Ranch, Inc. and of the conduct of M.R. Watters. We affirm the jury verdict on the question of corporate alter-ego. Furthermore, the record of defendant Watters conduct contains evidence on which a reasonable juror to find him personally liable for plaintiffs' injuries. Defendant M.R. Watters is liable to plaintiffs for his own negligence and that of defendant Wildhorn Ranch, Inc.

ORDER

We have considered the totality of the objections raised in defendants' post-trial motions as well as the complete trial record. Neither the facts of this case nor the applicable law warrant new trial, judgment notwithstanding the verdict, or amended judgment.

IT IS HEREBY ORDERED that claims stated against all defendants are STRICKEN; it is further

ORDERED that the Motion of Defendant M.R. Watters for Judgment Notwithstanding the Verdict, or, in the Alternative, for New Trial is DENIED; it is further

ORDERED that, in all particulars, the jury verdict on the question of corporate alter-ego attributing the negligence of Wildhorn Ranch, Inc. to M.R. Watters is affirmed;

Done this 14th day of December, 1988 at Denver, Colorado.

KINNEY SHOE CORPORATION, a New York corporation, Plaintiff-Appellant, v.
LINCOLN M. POLAN, Defendant-Appellee

United States Court of Appeals for the Fourth Circuit

939 F.2d 209
July 17, 1991, Decided

JUDGES: Hall, Circuit Judge, Chapman, Senior Circuit Judge, and Ward, Senior United States District Judge for the Middle District of North Carolina, sitting by designation.

OPINION BY: Chapman, Senior Circuit Judge

Plaintiff-appellant Kinney Shoe Corporation ("Kinney") brought this action in the United States District Court for the Southern District of West Virginia against Lincoln M. Polan ("Polan") seeking to recover money owed on a sublease between Kinney and Industrial Realty Company ("Industrial"). Polan is the sole shareholder of Industrial. The district court found that Polan was not personally liable on the lease between Kinney and Industrial. Kinney appeals asserting that the corporate veil should be pierced, and we agree.

I.

The district court based its order on facts which were stipulated by the parties. In 1984 Polan formed two corporations, Industrial and Polan Industries, Inc., for the purpose of re-establishing an industrial manufacturing business. The certificate of incorporation for Polan Industries, Inc. was issued by the West Virginia Secretary of State in November 1984. The following month the certificate of incorporation for Industrial was issued. Polan was the owner of both corporations. Although certificates of incorporation were issued, no organizational meetings were held, and no officers were elected.

In November 1984, Polan and Kinney began negotiating the sublease of a building in which Kinney held a leasehold interest. . . . The term of the sublease from Kinney to Industrial commenced in December 1984. On April 15, 1985, Industrial subleased part of the building to Polan Industries for fifty percent of the rental amount due Kinney. Polan signed both subleases on behalf of the respective companies.

Other than the sublease with Kinney, Industrial had no assets, no income and no bank account. Industrial issued no stock certificates because nothing was ever paid in to this corporation. Industrial's only income was from its sublease to Polan Industries, Inc. The first rental payment to Kinney was made out of Polan's personal funds, and no further payments were made by Polan or by Polan Industries, Inc. to either Industrial or to Kinney.

Kinney filed suit against Industrial for unpaid rent and obtained a judgment in the amount of $166,400.00 on June 19, 1987. A writ of possession was issued, but because Polan Industries, Inc. had filed for bankruptcy, Kinney did not gain possession for six months. Kinney leased the building until it was sold on September 1, 1988. Kinney then filed this action against Polan individually to collect the amount owed by Industrial to Kinney. Since the amount to which Kinney is entitled is undisputed, the only issue is whether Kinney can pierce the corporate veil and hold Polan personally liable.

The district court held that Kinney had assumed the risk of Industrial's undercapitalization and was not entitled to pierce the corporate veil. Kinney appeals, and we reverse.

II.

We have long recognized that a corporation is an entity, separate and distinct from its officers and stockholders, and the individual stockholders are not responsible for the debts of the corporation. This concept, however, is a fiction of the law "'and it is now well settled, as a general principle, that the fiction should be disregarded when it is urged with an intent not within its reason and purpose, and in such a way that its retention would produce injustices or inequitable consequences.'" *Laya v. Erin Homes, Inc.*, 352 S.E.2d 93 (W. Va. 1986).

Piercing the corporate veil is an equitable remedy, and the burden rests with the party asserting such claim. [citations omitted] A totality of the circumstances test is used in determining whether to pierce the corporate veil, and each case must be decided on its own facts. The district court's findings of facts may be overturned only if clearly erroneous.

Kinney seeks to pierce the corporate veil of Industrial so as to hold Polan personally liable on the sublease debt. The Supreme Court of Appeals of West Virginia has set forth a two prong test to be used in determining whether to pierce a corporate veil in a breach of contract case. This test raises two issues: first, is the unity of interest and ownership such that the separate personalities of the corporation and the individual shareholder no longer exist; and second, would an equitable result occur if the acts are treated as those of the corporation alone. *Laya*, 352 S.E.2d 99. Numerous factors have been identified as relevant in making this determination. *

* The following factors were identified in *Laya*:

> (1) commingling of funds and other assets of the corporation with those of the individual shareholders;
>
> (2) diversion of the corporation's funds or assets to noncorporate uses (to the personal uses of the corporation's shareholders);
>
> (3) failure to maintain the corporate formalities necessary for the issuance of or subscription to the corporation's stock, such as formal approval of the stock issue by the board of directors;
>
> (4) an individual shareholder representing to persons outside the corporation that he or she is personally liable for the debts or other obligations of the corporation;
>
> (5) failure to maintain corporate minutes or adequate corporate records; . . . .
>
> (8) failure to adequately capitalize a corporation for the reasonable risks of the corporate undertaking;
>
> (9) absence of separately held corporate assets;
>
> (10) use of a corporation as a mere shell or conduit to operate a single venture or some particular aspect of the business of an individual or another corporation;
>
> (11) sole ownership of all the stock by one individual or members of a single family;
>
> (12) use of the same office or business location by the corporation and its individual shareholder(s); . . . .
>
> (15) disregard of legal formalities and failure to maintain proper arm's length relationships among related entities; . . . .
>
> (17) diversion of corporate assets from the corporation by or to a stockholder or other person or entity to the detriment of creditors, or the manipulation of assets and liabilities between entities to concentrate the assets in one and the liabilities in another;
>
> (18) contracting by the corporation with another person with the intent to avoid risk of nonperformance by use of the corporate entity; or the use of a corporation as a subterfuge for illegal transactions;

The district court found that the two prong test of *Laya* had been satisfied. The court concluded that Polan's failure to carry out the corporate formalities with respect to Industrial, coupled with Industrial's gross undercapitalization, resulted in damage to Kinney. We agree.

It is undisputed that Industrial was not adequately capitalized. Actually, it had no paid in capital. Polan had put nothing into this corporation, and it did not observe any corporate formalities. As the West Virginia court stated in *Laya*, "'individuals who wish to enjoy limited personal liability for business activities under a corporate umbrella should be expected to adhere to the relatively simple formalities of creating and maintaining a corporate entity.'" This, the court stated, is "'a relatively small price to pay for limited liability.'" *Id.* Another important factor is adequate capitalization. "Grossly inadequate capitalization combined with disregard of corporate formalities, causing basic unfairness, are sufficient to pierce the corporate veil in order to hold the shareholder(s) actively participating in the operation of the business personally liable for a breach of contract to the party who entered into the contract with the corporation." *Id.*

In this case, Polan bought no stock, made no capital contribution, kept no minutes, and elected no officers for Industrial. In addition, Polan attempted to protect his assets by placing them in Polan Industries, Inc. and interposing Industrial between Polan Industries, Inc. and Kinney so as to prevent Kinney from going against the corporation with assets. Polan gave no explanation or justification for the existence of Industrial as the intermediary between Polan Industries, Inc. and

Kinney. Polan was obviously trying to limit his liability and the liability of Polan Industries, Inc. by setting up a paper curtain constructed of nothing more than Industrial's certificate of incorporation. These facts present the classic scenario for an action to pierce the corporate veil so as to reach the responsible party and produce an equitable result. Accordingly, we hold that the district court correctly found that the two prong test in *Laya* had been satisfied.

In *Laya*, the court also noted that when determining whether to pierce a corporate veil a third prong may apply in certain cases. The court stated:

> When, under the circumstances, it would be reasonable for that particular type of a party [those contract creditors capable of protecting themselves] entering into a contract with the corporation, for example, a bank or other lending institution, to conduct an investigation of the credit of the corporation prior to entering into the contract, such party will be charged with the knowledge that a reasonable credit investigation would disclose. If such an investigation would disclose that the corporation is grossly undercapitalized, based upon the nature and the magnitude of the corporate undertaking, such party will be deemed to have assumed the risk of the gross undercapitalization and will not be permitted to pierce the corporate veil.

Laya, 352 S.E.2d at 100. The district court applied this third prong and concluded that Kinney "assumed the risk of Industrial's defaulting" and that "the application of the doctrine of 'piercing the corporate veil' ought not and does not [apply]." While we agree that the two prong test of *Laya* was satisfied, we hold that the district court's conclusion that Kinney had assumed the risk is clearly erroneous.

Without deciding whether the third prong should be extended beyond the context of the financial institution lender mentioned in *Laya*, we hold that, even if it applies to creditors such as Kinney, it does not prevent Kinney from piercing the corporate veil in this case. The third prong is permissive and not mandatory. This is not a factual situation that calls for the third prong, if we are to seek an equitable result. Polan set up Industrial to limit his liability and the liability of Polan Industries, Inc. in their dealings with Kinney. A stockholder's liability is limited to the amount he has invested in the corporation, but Polan invested nothing in Industrial. This corporation was no more than a shell--a transparent shell. When nothing is invested in the corporation, the corporation provides no protection to its owner; nothing in, nothing out, no protection. If Polan wishes the protection of a corporation to limit his liability, he must follow the simple formalities of maintaining the corporation. This he failed to do, and he may not relieve his circumstances by saying Kinney should have known better.

III.

For the foregoing reasons, we hold that Polan is personally liable for the debt of Industrial, and the decision of the district court is reversed and this case is remanded with instructions to enter judgment for the plaintiff.

REVERSED AND REMANDED WITH INSTRUCTIONS

Smith v. Van Gorkom

Supreme Court of Delaware

488 A.2d 858

January 29, 1985, Decided

JUDGES: Horsey, Justice (for the majority). Herrmann, C.J., and McNeilly, Moore and Christie, JJ., constituting the Court En Banc. McNeilly, Justice, dissenting. Christie, Justice, dissenting.

OPINION:

Trans Union was a publicly-traded, diversified holding company, the principal earnings of which were generated by its railcar leasing business. During the period here involved, the Company had a cash flow of hundreds of millions of dollars annually. However, the Company had difficulty in generating sufficient taxable income to offset increasingly large investment tax credits (ITCs). . . .

On August 27, 1980, Van Gorkom met with Senior Management of Trans Union. Various alternatives were suggested and discussed preliminarily, including the sale of Trans Union to a company with a large amount of taxable income. At this meeting, Van Gorkom stated that he would be willing to take $55 per share for his own 75,000 shares. . . . Van Gorkom, a certified public accountant and lawyer, had been an officer of Trans Union for 24 years, its Chief Executive Officer for more than 17 years, and Chairman of its Board for 2 years. He was then approaching 65 years of age and mandatory retirement.

For several days following the September 5 meeting, Van Gorkom pondered the idea of a sale. He had participated in many acquisitions as a manager and director of Trans Union and as a director of other companies. He was familiar with acquisition procedures, valuation methods, and negotiations; and he privately considered the pros and cons of whether Trans Union should seek a privately or publicly-held purchaser.

Van Gorkom decided to meet with Jay A. Pritzker, a well-known corporate takeover specialist and a social acquaintance. However, rather than approaching Pritzker simply to determine his interest in acquiring Trans Union, Van Gorkom assembled a proposed per share price for sale of the Company and a financing structure by which to accomplish the sale. Van Gorkom did so without consulting either his Board or any members of Senior Management except one: Carl Peterson, Trans Union's Controller. Telling Peterson that he wanted no other person on his staff to know what he was doing, but without telling him why, Van Gorkom directed Peterson to calculate the feasibility of a leveraged buy-out at an assumed price per share of $55. Apart from the historic stock market price, and Van Gorkom's long association with Trans Union, the record is devoid of any competent evidence that $55 represented the per share intrinsic value of the Company. . . .

Van Gorkom arranged a meeting with Pritzker at the latter's home on Saturday, September 13, 1980. . . .

Van Gorkom then reviewed with Pritzker his calculations based upon his proposed price of $55 per share. Although Pritzker mentioned $50 as a more attractive figure, no other price was mentioned. However, Van Gorkom stated that to be sure that $55 was the best price obtainable, Trans Union should be free to accept any better offer. . . .

On Monday, September 15, Pritzker advised Van Gorkom that he was interested in the $55 cash-out merger proposal. . . Van Gorkom was "astounded that events were moving with such amazing rapidity."

On Thursday, September 18, Van Gorkom met again with Pritzker. At that time, Van Gorkom knew that Pritzker intended to make a cash-out merger offer at Van Gorkom's proposed $55 per share. Pritzker instructed his attorney, a merger and acquisition specialist, to begin drafting merger documents. There was no further discussion of the $55 price. . . . At this point, Pritzker insisted that the Trans Union Board act on his merger proposal within the next three days. . . .

On Friday, September 19, Van Gorkom called a special meeting of the Trans Union Board for noon the following day. He also called a meeting of the Company's Senior Management to convene at 11:00 a.m., prior to the meeting of the Board. No one, except Chelberg and Peterson, was told the purpose of the meetings. Van Gorkom did not invite Trans Union's investment banker, Salomon Brothers, to attend.

Of those present at the Senior Management meeting on September 20, only Chelberg and Peterson had prior knowledge of Pritzker's offer. Van Gorkom disclosed the offer and described its terms, but he furnished no copies of the proposed Merger Agreement.

Senior Management's reaction to the Pritzker proposal was completely negative. No member of Management, except Chelberg and Peterson, supported the proposal. Romans objected to the price as being too low; he was critical of the timing and suggested that consideration should be given to the adverse tax consequences of an all-cash deal for low-basis shareholders; and he took the position that the agreement to sell Pritzker one million newly-issued shares at market price would inhibit other offers, as would the prohibitions against soliciting bids and furnishing inside information to other bidders. Romans argued that the Pritzker proposal was a "lock up" and amounted to "an agreed merger as opposed to an offer." Nevertheless, Van Gorkom proceeded to the Board meeting as scheduled without further delay.

Ten directors served on the Trans Union Board, five inside and five outside. All directors were present at the meeting, except O'Boyle who was ill. Of the outside directors, four were corporate chief executive officers and one was the former Dean of the University of Chicago Business School. None was an investment banker or trained financial analyst. All members of the Board were well informed about the Company and its operations as a going concern. They were familiar with the current financial condition of the Company, as well as operating and earnings projections reported in the recent Five Year Forecast.

Van Gorkom began the Special Meeting of the Board with a twenty-minute oral presentation. Copies of the proposed Merger Agreement were delivered too late for study before or during the meeting. . . . Van Gorkom did not disclose to the Board, however, the methodology by which he alone had arrived at the $55 figure, or the fact that he first proposed the $55 price in his negotiations with Pritzker. . . .

Van Gorkom took the position that putting Trans Union "up for auction" through a 90-day market test would validate a decision by the Board that $55 was a fair price. He told the Board that the "free market will have an opportunity to judge whether $55 is a fair price." Van Gorkom framed the decision before the Board not as whether $55 per share was the highest price that could be obtained, but as whether the $55 price was a fair price that the stockholders should be given the opportunity to accept or reject.

Attorney Brennan advised the members of the Board that they might be sued if they failed to accept the offer and that a fairness opinion was not required as a matter of law.

Romans attended the meeting as chief financial officer of the Company. He told the Board that he had not been involved in the negotiations with Pritzker and knew nothing about the merger proposal until the morning of the meeting; that his studies did not indicate either a fair price for the stock or a valuation of the Company. . . . Romans told the Board that, in his opinion, $55 was "in the range of a fair price," but "at the beginning of the range." . . .

The Board meeting of September 20 lasted about two hours. Based solely upon Van Gorkom's oral presentation, Chelberg's supporting representations, Romans' oral statement, Brennan's legal advice, and their knowledge of the market history of the Company's stock, the directors approved the proposed Merger Agreement. . . .

The Merger Agreement was executed by Van Gorkom during the evening of September 20 at a formal social event that he hosted for the opening of the Chicago Lyric Opera. Neither he nor any other director read the agreement prior to its signing and delivery to Pritzker.

Salomon Brothers' efforts over a three-month period from October 21 to January 21 produced only one serious suitor for Trans Union — General Electric Credit Corporation, a subsidiary of the General Electric Company. However, GE Credit was unwilling to make an offer for Trans Union unless Trans Union first rescinded its Merger Agreement with Pritzker. When Pritzker refused, GE Credit terminated further discussions with Trans Union in early January. In the meantime, in early December, the investment firm of Kohlberg, Kravis, Roberts & Co. ("KKR"), the only other concern to make a firm offer for Trans Union, withdrew its offer under circumstances hereinafter detailed. . . .

On February 10, the stockholders of Trans Union approved the Pritzker merger proposal. Of the outstanding shares, 69.9% were voted in favor of the merger; 7.25% were voted against the merger; and 22.85% were not voted.

II.

We turn to the issue of the application of the business judgment rule to the September 20 meeting of the Board. . . .

Under Delaware law, the business judgment rule is the offspring of the fundamental principle, codified in 8 *Del.C.* § 141 (a), that the business and affairs of a Delaware corporation are managed by or under its board of directors. . . . In carrying out their managerial roles, directors are charged with an unyielding fiduciary duty to the corporation and its shareholders. The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors. The rule itself "is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Thus, the party attacking a board decision as uninformed must rebut the presumption that its business judgment was an informed one.

The determination of whether a business judgment is an informed one turns on whether the directors have informed themselves "prior to making a business decision, of all material information reasonably available to them."

Under the business judgment rule there is no protection for directors who have made "an unintelligent or unadvised judgment." . . . .

We think the concept of gross negligence is the proper standard for determining whether a business judgment reached by a board of directors was an informed one.

It is against those standards that the conduct of the directors of Trans Union must be tested, as a matter of law and as a matter of fact, regarding their exercise of an informed business judgment in voting to approve the Pritzker merger proposal.

III.

The issue of whether the directors reached an informed decision to "sell" the Company on September 20, 1980 must be determined only upon the basis of the information then reasonably available to the directors and relevant to their decision to accept the Pritzker merger proposal. . . .

On the record before us, we must conclude that the Board of Directors did not reach an informed business judgment on September 20, 1980 in voting to "sell" the Company for $55 per share pursuant to the Pritzker cash-out merger proposal.

Our reasons, in summary, are as follows: The directors (1) did not adequately inform themselves as to Van Gorkom's role in forcing the "sale" of the Company and in establishing the per share purchase price; (2) were uninformed as to the intrinsic value of the Company; and (3) given these circumstances, at a minimum, were grossly negligent in approving the "sale" of the Company upon two hours' consideration, without prior notice, and without the exigency of a crisis or emergency.

As has been noted, the Board based its September 20 decision to approve the cash-out merger primarily on Van Gorkom's representations. None of the directors, other than Van Gorkom and Chelberg, had any prior knowledge that the purpose of the meeting was to propose a cash-out merger of Trans Union. No members of Senior Management were present, other than Chelberg, Romans and Peterson; and the latter two had only learned of the proposed sale an hour earlier. Both general counsel Moore and former general counsel Browder attended the meeting, but were equally uninformed as to the purpose of the meeting and the documents to be acted upon.

Without any documents before them concerning the proposed transaction, the members of the Board were required to rely entirely upon Van Gorkom's 20-minute oral presentation of the proposal. No written summary of the terms of the merger was presented; the directors were given no documentation to support the adequacy of $55 price per share for sale of the Company; and the Board had before it nothing more than Van Gorkom's statement of his understanding of the substance of an agreement which he admittedly had never read, nor which any member of the Board had ever seen.

A substantial premium may provide one reason to recommend a merger, but in the absence of other sound valuation information, the fact of a premium alone does not provide an adequate basis upon which to assess the fairness of an offering price. Here, the judgment reached as to the adequacy of the premium was based on a comparison between the historically depressed Trans Union market price and the amount of the Pritzker offer. Using market price as a basis for concluding that the premium adequately reflected the true value of the Company was a clearly faulty, indeed fallacious, premise, as the defendants' own evidence demonstrates.

The record is clear that before September 20, Van Gorkom and other members of Trans Union's Board knew that the market had consistently undervalued the worth of Trans Union's stock, despite steady increases in the Company's

operating income in the seven years preceding the merger. . . . Yet, on September 20, Trans Union's Board apparently believed that the market stock price accurately reflected the value of the Company for the purpose of determining the adequacy of the premium for its sale. . .

There was no call by the Board, either on September 20 or thereafter, for any valuation study or documentation of the $55 price per share as a measure of the fair value of the Company in a cash-out context. It is undisputed that the major asset of Trans Union was its cash flow. Yet, at no time did the Board call for a valuation study taking into account that highly significant element of the Company's assets.

We do not imply that an outside valuation study is essential to support an informed business judgment; nor do we state that fairness opinions by independent investment bankers are required as a matter of law. Often insiders familiar with the business of a going concern are in a better position than are outsiders to gather relevant information; and under appropriate circumstances, such directors may be fully protected in relying in good faith upon the valuation reports of their management.

Here, the record establishes that the Board did not request its Chief Financial Officer, Romans, to make any valuation study or review of the proposal to determine the adequacy of $55 per share for sale of the Company. . . . Had the Board, or any member, made an inquiry of Romans, he presumably would have responded as he testified: that his calculations were rough and preliminary; and, that the study was not designed to determine the fair value of the Company, but rather to assess the feasibility of a leveraged buy-out financed by the Company's projected cash flow, making certain assumptions as to the purchaser's borrowing needs. Romans would have presumably also informed the Board of his view, and the widespread view of Senior Management, that the timing of the offer was wrong and the offer inadequate.

The record also establishes that the Board accepted without scrutiny Van Gorkom's representation as to the fairness of the $55 price per share for sale of the Company. . . . No questions were raised either as to the tax implications of a cash-out merger or how the price for the one million share option granted Pritzker was calculated.

We do not say that the Board of Directors was not entitled to give some credence to Van Gorkom's representation that $55 was an adequate or fair price. The directors were entitled to rely upon their chairman's opinion of value and adequacy, provided that such opinion was reached on a sound basis. Here, the issue is whether the directors informed themselves as to all information that was reasonably available to them. Had they done so, they would have learned of the source and derivation of the $55 price and could not reasonably have relied thereupon in good faith.

None of the directors, Management or outside, were investment bankers or financial analysts. Yet the Board did not consider recessing the meeting until a later hour that day (or requesting an extension of Pritzker's Sunday evening deadline) to give it time to elicit more information as to the sufficiency of the offer, either from inside Management (in particular Romans) or from Trans Union's own investment banker, Salomon Brothers, whose Chicago specialist in merger and acquisitions was known to the Board and familiar with Trans Union's affairs.

Thus, the record compels the conclusion that on September 20 the Board lacked valuation information adequate to reach an informed business judgment as to the fairness of $55 per share for sale of the Company. . . .

We conclude that Trans Union's Board was grossly negligent in that it failed to act with informed reasonable deliberation in agreeing to the Pritzker merger proposal on September 20. . . . We conclude that the director defendants breached their fiduciary duty of candor by their failure to make true and correct disclosures of all information they had, or should have had, material to the transaction submitted for stockholder approval.

VI

To summarize: we hold that the directors of Trans Union breached their fiduciary duty to their stockholders (1) by their failure to inform themselves of all information reasonably available to them and relevant to their decision to recommend the Pritzker merger; and (2) by their failure to disclose all material information such as a reasonable stockholder would consider important in deciding whether to approve the Pritzker offer. . . .

On remand, the Court of Chancery shall conduct an evidentiary hearing to determine the fair value of the shares represented by the plaintiffs' class, based on the intrinsic value of Trans Union on September 20, 1980. . . . Thereafter, an award of damages may be entered to the extent that the fair value of Trans Union exceeds $55 per share.

REVERSED and REMANDED for proceedings consistent herewith.

In the Matter of the Appraisal of Shell Oil Company

Supreme Court of Delaware

607 A.2d 1213

May 26, 1992, Decided

JUDGES: MOORE, WALSH, Justices and TAYLOR, Judge
OPINION BY: Walsh , Justice

This is an appeal from a decision of the Court of Chancery in an appraisal action. Petitioners ("petitioners"), former minority shareholders of respondent Shell Oil Company ("Shell"), sought an appraisal of the fair value of Shell's common stock on June 7, 1985, the date shareholders were cashed out at $58 per share. The cash out resulted from a short-form merger effectuated by Shell's 94.6 percent majority stockholder, respondent below-appellant Shell Petroleum, Inc., as required by a court approved settlement of an earlier class action.

The Court of Chancery determined that the fair value of the shareholders' stock was $71.20 per share at the time of the merger. . . . In this appeal, Shell challenges the Court of Chancery's fair value determination.

We have carefully reviewed the record in this case and have concluded that there is sufficient evidence to support the findings of the Court of Chancery. Accordingly, the decision of the Court of Chancery is affirmed.

I

The events leading up to the privatization of Shell and the extensive litigation it spawned are described in detail elsewhere. We will therefore summarize it briefly.

Prior to the merger which precipitated these proceedings, Shell was a publicly traded oil and gas company with substantial assets throughout the world. It was, however, only one component of a much larger natural resources conglomerate, Royal Dutch Petroleum Company ("Royal Dutch"). Royal Dutch controlled, either directly or through subsidiary holdings, over 70 percent of Shell's outstanding shares.

During the early 1980's, Royal Dutch began considering the acquisition of Shell's minority shares. It retained in 1984, the investment banking firm of Morgan Stanley & Co. ("Morgan Stanley") to prepare an estimate of the value of Shell stock. Morgan Stanley opined that a share of Shell stock was worth $53. Royal Dutch thereafter proposed to Shell's Board of Directors that Shell merge with Royal Dutch for $55 cash for each share of Shell stock.

In response to this offer by its majority stockholder, Shell's board appointed an independent committee comprised of six outside directors to consider the offer. The committee retained the firm of Goldman Sachs & Co. ("Goldman Sachs") as its financial advisor and commissioned a study of the fair value of Shell stock. In the resulting study, Goldman Sachs concluded that $80 to $85 per share was a range of "high confidence" and that $70 per share was the lowest price it could say was fair. The committee recommended that the Shell Board reject the Royal Dutch offer.

Royal Dutch then commenced a tender offer for any and all shares at a price of $58 per share with the intention of effectuating a freeze-out merger after completion of the offer. It completed the offer in 1984, increasing its holdings in Shell to 94.6 percent.

II

After the merger was complete, 1,005,081 shares qualified for appraisal under 8 *Del. C.* § 262. The Court of Chancery conducted an appraisal hearing which lasted seven days. The parties offered extensive evidence, primarily through competing experts, respecting the value of Shell shares as of the date of the merger.

Petitioners' chief witness was Kurt Wulff ("Wulff"), a chemical engineer and graduate of the Harvard Business School. Wulff's experience in the oil and gas field spanned twenty years and included financial analysis and asset valuation. To arrive at a fair value for Shell shares, he employed three different approaches. First, he offered what he called a Present Value of Equity Analysis. . . . Wulff concluded that under this method a share of Shell stock on June 7, 1985 was worth between $89 and $100.

Second, Wulff offered what he termed a Comparative Deal Market Analysis.. . . After comparing the transaction at issue here with seventeen other industry acquisitions, Wulff fixed the fair value of a share of Shell stock on the merger date at approximately $106.

Wulff's final valuation standard he referred to as a Trading Market Analysis. . . . Depending on which comparable was selected, Wulff found a range in value from $92 to $143 per share.

Shell's expert, Morgan Stanley, took a three pronged approach in its valuation of Shell. It offered a liquidation study using a discounted cash flow of Shell's upstream assets and an estimate of the value of Shell's downstream assets based largely on a trading market analysis. This methodology yielded a valuation of $57.50 per share at the time of merger.

Next, Morgan Stanley offered what it called a Merger Market Analysis. This technique is similar to Wulff's Comparative Deal Market Analysis in that it involved a comparison of Shell to other similar companies which had experienced acquisition. Morgan Stanley concluded that this method suggested a fair value of $60 per share.

Finally, Morgan Stanley offered its own Trading Market Analysis based on a calculation of what Shell stock would have traded for had there been no merger offer. The quest here was to determine an "unaffected stock price." . . . The conclusion of this analysis was that Shell was worth $43 to $45 per share on June 7, 1985.

III

In an extensive opinion, the Vice-Chancellor addressed the merits and deficiencies of the competing value studies. He found neither of the trading market analyses particularly convincing. He assigned no weight to Wulff's Trading Market Analysis due to numerous flaws in the method used to arrive at the price range of $92 to $143. . . . As for Morgan Stanley's Trading Market Analysis, the court concluded that Morgan Stanley's finding that Shell stock in June of 1985 would have experienced no change from its January, 1984 price notwithstanding a substantial rise in the market price of other oil stocks during the same period, was "highly illogical." This rejection was consistent with the court's earlier finding that Shell was "a superior company to most of those studied by Morgan Stanley and should have been priced above the median." The court therefore afforded Morgan Stanley's Trading Market Analysis very little weight.

The Vice Chancellor also assigned little weight to the proffered techniques based on comparing the Shell transaction to other similar "deals." Morgan Stanley's Merger Market Analysis fared little better. The Vice Chancellor found that Morgan Stanley's calculations were often too "pessimistic" and that Morgan Stanley failed to accord sufficient weight to Shell's more valuable domestic reserves, as opposed to its less valuable foreign reserves. The court concluded that the Morgan Stanley's Merger Market Analysis was "less valid" than its Liquidation Value Analysis.

As to the parties' liquidation value techniques, the court found both to be valid methodologies but somewhat flawed in their application. . . . The court commented that "in preparing its estimate [Morgan Stanley] made hundreds of assumptions as to the value of a particular asset. In most instances it chose the lower, rather than the higher value. . . . It is therefore clear that Morgan Stanley's Liquidation Analysis is substantially flawed."

After reviewing the valuation evidence in its effort to fix the fair value of Shell stock on the date of the merger, the Court of Chancery expressed some dissatisfaction with the lack of objectivity in the presentations. The court noted that it was "obvious . . . that the dynamics of this litigation and the economic interest of the parties contributed to the wide differences in the expert opinions" but the court nonetheless believed it was limited "to the record as established by the parties." On balance, however, the court accepted Wulff's Present Value of Equity Analysis ($89) and Morgan Stanley's Liquidation Value Analysis ($57.50) as the most credible methodologies.

The court finally settled on Wulff's Present Value of Equity Analysis as entitled to the greatest weight. However, because of certain flaws in Wulff's data which tended to skew the result upward, the court applied a twenty percent discount to the $89 figure, producing a fair value for Shell stock of $71.20. The court gave no explanation for its choice of twenty percent as a discount factor.

It is noted that this figure [$71.20] is not far from the $70 per share "low" value arrived at by Goldman Sachs in 1984 when it prepared an estimate of value for the Independent Committee of Shell appointed to consider the offer of Holdings.

The court then awarded the dissenting shareholders simple interest at a rate of 10 percent per year.

In this appeal both parties express dissatisfaction with the Vice Chancellor's ruling.

IV

The legal standards which govern an appraisal of minority shares after a freeze-out merger are not disputed by the parties. Once a shareholder perfects his right to appraisal under 8 *Del. C.* § 262(d), the Court of Chancery is required to determine the "fair value" of his shares, "exclusive of any element of value arising from the accomplishment or expectation of the merger," by considering "all relevant factors." Fair value, in an appraisal context, measures "that which has been taken from [the shareholder], *viz.,* his proportionate interest in a going concern." In the appraisal process the corporation is valued "as an entity," not merely as a collection of assets, or by the sum of the market price of each share of its stock, Moreover, the corporation must be viewed as an on-going enterprise, occupying a particular market position in the light of future prospects.

The appraisal quest at the Court of Chancery level admits of a broad latitude. . . . At the appellate level, when this Court reviews a Court of Chancery determination, we impart a "high level of deference" to that court's findings. Recognizing that the Court of Chancery, over time, has developed an expertise in cases of this type, we will accept the court's findings if supported by the record and the product of an orderly and logical deductive process. We will reverse those findings only when they are clearly wrong and justice requires us. . .

At trial, the court was offered six valuation techniques, three from each side and it made discriminating judgments concerning them. As noted, it found that Wulff's Present Value of Equity Analysis, "although seriously flawed, must be given considerable weight."

As for Shell's evidence, the court found Morgan Stanley's Liquidation Value Analysis to be "substantially flawed" but concluded that it was one of "the two most creditable methodologies presented." Far from relying solely on Wulff's Present Value of Equity Analysis, the Vice Chancellor credited each technique offered except Wulff's Trading Market Analysis, which he rejected because of its premise that Shell stock should command a premium over market value. In discounting the Present Value of Equity result, the court was recognizing, tacitly at least, that Shell's evidence, which tended to undervaluation, was entitled to some consideration. When so viewed, the court's final figure of $71.20 is clearly supportable and not the product of a liquidation analysis alone. . . .

Here the final value chosen ($71.20) is very close to the mid-way mark between the two values the court found to be most credible, $89.00 (Present Value of Equity) and $57.50 (Morgan Stanley's Liquidation Value).

The trial court's selection of $71.20 per share was also verified by comparison with another view not directly tendered by the parties. The Goldman Sachs opinion, prepared in 1984 for Shell's Independent Committee, fixed $70 as at the low end of the range of fairness. That independent assessment imparted an inference of reasonableness to the court's finding. . . . Given our standard of review, we cannot say the trial court's resulting conclusion was not the product of an orderly and logical deductive process. . . . The Vice Chancellor's conclusions are amply supported by the record and the product of an orderly and logical deductive process. We therefore decline to disturb them.

V

Petitioners have also appealed from the Vice Chancellor's awarding of simple interest. [discussion omitted]

VI

Although our affirmance of the Court of Chancery's appraisal determination resolves the merits of this appeal, we take the occasion to comment upon a recurring theme in recent appraisal cases — the clash of contrary expert opinions on value. The presentation of widely divergent views reflecting partisan positions in appraisal proceedings adds to the burden of the Court of Chancery's task of fixing value. Such extremes may result in the court's rejection of both opinions in favor of a middle position. We impute no impropriety to the participants in this or other appraisal litigation in their efforts to advance their respective positions. That is to be expected in an adversarial system. But if the Court is limited to the biased presentation of the parties, it is often forced to pick and choose from a limited record without the benefit of objective analysis and opinion. To compensate for this handicap, the Court of Chancery should consider, in a proper case, appointing its own expert witness. . . . We do not mandate the use of court appointed experts, leaving such determination to the discretion of the trial judge, but we believe the time has come for the Court of Chancery to avail itself of such a practice whenever it believes that a more objective presentation of evidence is required, particularly in valuation matter.

CTS CORP. v. DYNAMICS CORPORATION OF AMERICA

SUPREME COURT OF THE UNITED STATES

481 U.S. 69

April 21, 1987, Decided

JUDGES: Powell, J., delivered the opinion of the Court, in which Rehnquist, C. J., and Brennan, Marshall, Scalia and O'Connor, JJ., joined. White, J., filed a dissenting opinion, of which Blackmun and Stevens, JJ., joined.

JUSTICE POWELL delivered the opinion of the Court.

These cases present the questions whether the Control Share Acquisitions Chapter of the Indiana Business Corporation Law is pre-empted by the Williams Act or violates the Commerce Clause of the U.S. Constitution, Art. I, § 8, cl. 3.

I.

On March 4, 1986, the Governor of Indiana signed the Control Share Acquisitions Chapter (Indiana Act or Act). Beginning on August 1, 1987, the Act will apply to any corporation incorporated in Indiana, unless the corporation amends its articles of incorporation or bylaws to opt out of the Act. The Act applies only to "issuing public corporations." The term "corporation" includes only businesses incorporated in Indiana. An "issuing public corporation" is defined as:

> "a corporation that has:
>
> "(1) one hundred (100) or more shareholders;
>
> "(2) its principal place of business, its principal office, or substantial assets within Indiana; and
>
> "(3) either:
>
> > "(A) more than ten percent (10%) of its shareholders resident in Indiana;
> >
> > "(B) more than ten percent (10%) of its shares owned by Indiana residents; or
> >
> > "(C) ten thousand (10,000) shareholders resident in Indiana."

The Act focuses on the acquisition of "control shares" in an issuing public corporation. Under the Act, an entity acquires "control shares" whenever it acquires shares that, but for the operation of the Act, would bring its voting power in the corporation to or above any of three thresholds: 20%, 33 1/3%, or 50%. An entity that acquires control shares does not necessarily acquire voting rights. Rather, it gains those rights only "to the extent granted by resolution approved by the shareholders of the issuing public corporation." The Act requires a majority vote of all disinterested shareholders holding each class of stock for passage of such a resolution. The practical effect of this requirement is to condition acquisition of control of a corporation on approval of a majority of the pre-existing disinterested shareholders.

The shareholders decide whether to confer rights on the control shares at the next regularly scheduled meeting of the shareholders, or at a specially scheduled meeting. . . . If the shareholders do not vote to restore voting rights to the shares, the corporation may redeem the control shares from the acquiror at fair market value, but it is not required to do so. . . .

On March 10, 1986, appellee Dynamics Corporation of America (Dynamics) owned 9.6% of the common stock of appellant CTS Corporation, an Indiana corporation. On that day, six days after the Act went into effect, Dynamics announced a tender offer for another million shares in CTS; purchase of those shares would have brought Dynamics' ownership interest in CTS to 27.5%. Also on March 10, Dynamics filed suit in the United States District Court for the Northern District of Illinois, alleging that CTS had violated the federal securities laws in a number of respects no longer relevant to these proceedings. On March 27, the board of directors of CTS, an Indiana corporation, elected to be governed by the provisions of the Act.

Dynamics sought a temporary restraining order, a preliminary injunction, and declaratory relief against CTS' use of the Act. On April 9, the District Court ruled that the Williams Act pre-empts the Indiana Act and granted Dynamics' motion for declaratory relief. . . . CTS appealed the District Court's holdings on these claims to the Court of Appeals for the Seventh Circuit.

After disposing of a variety of questions not relevant to this appeal, the Court of Appeals examined Dynamics' claim that the Williams Act pre-empts the Indiana Act. The court found the case straightforward: [the Williams Act does pre-empt the Indiana Act].

The court next addressed Dynamic's Commerce Clause challenge to the Act. The court found the Act unconstitutional:

Accordingly, the court affirmed the judgment of the District Court. Both Indiana and CTS filed jurisdictional statements. We noted probable jurisdiction and now reverse.

II.

The first question in these cases is whether the Williams Act pre-empts the Indiana Act. As we have stated frequently, absent an explicit indication by Congress of an intent to pre-empt state law, a state statute is pre-empted only "'where compliance with both federal and state regulations is a physical impossibility . . . ,' or where the state 'law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.'

Because it is entirely possible for entities to comply with both the Williams Act and the Indiana Act, the state statute can be pre-empted only if it frustrates the purposes of the federal law.

Congress passed the Williams Act in 1968 in response to the increasing number of hostile tender offers. Before its passage, these transactions were not covered by the disclosure requirements of the federal securities laws. The Williams Act, backed by regulations of the SEC, imposes requirements in two basic areas. First, it requires the offeror to file a statement disclosing information about the offer, including: the offeror's background and identity; the source and amount of the funds to be used in making the purchase; the purpose of the purchase, including any plans to liquidate the company or make major changes in its corporate structure; and the extent of the offeror's holdings in the target company.

Second, the Williams Act, and the regulations that accompany it, establish procedural rules to govern tender offers. For example, stockholders who tender their shares may withdraw them while the offer remains open, and, if the offeror has not purchased their shares, any time after 60 days from commencement of the offer. The offer must remain open for at least 20 business days. If more shares are tendered than the offeror sought to purchase, purchases must be made on a pro rata basis from each tendering shareholder. Finally, the offeror must pay the same price for all purchases; if the offering price is increased before the end of the offer, those who already have tendered must receive the benefit of the increased price.

The Indiana Act operates on the assumption, implicit in the Williams Act, that independent shareholders faced with tender offers often are at a disadvantage. By allowing such shareholders to vote as a group, the Act protects them from the coercive aspects of some tender offers. If, for example, shareholders believe that a successful tender offer will be followed by a purchase of nontendering shares at a depressed price, individual shareholders may tender their shares — even if they doubt the tender offer is in the corporation's best interest — to protect themselves from being forced to sell their shares at a depressed price. . . . In such a situation under the Indiana Act, the shareholders as a group, acting in the corporation's best interest, could reject the offer, although individual shareholders might be inclined to accept it. The desire of the Indiana Legislature to protect shareholders of Indiana corporations from this type of coercive offer does not conflict with the Williams Act. Rather, it furthers the federal policy of investor protection. . . .

Nothing in the Act prohibits an offeror from consummating an offer on the 20th business day, the earliest day permitted under applicable federal regulations. Nor does the Act allow the state government to interpose its views of fairness between willing buyers and sellers of shares of the target company. Rather, the Act allows *shareholders* to evaluate the fairness of the offer collectively.

In our view, the possibility that the Indiana Act will delay some tender offers is insufficient to require a conclusion that the Williams Act pre-empts the Act. The longstanding prevalence of state regulation in this area suggests that, if Congress had intended to pre-empt all state laws that delay the acquisition of voting control following a tender offer, it would have said so explicitly. The regulatory conditions that the Act places on tender offers are consistent with the text and the purposes of the Williams Act. Accordingly, we hold that the Williams Act does not pre-empt the Indiana Act.

III.

As an alternative basis for its decision, the Court of Appeals held that the Act violates the Commerce Clause of the Federal Constitution. We now address this holding. On its face, the Commerce Clause is nothing more than a grant to Congress of the power "to regulate Commerce . . . among the several States . . . ," Art. I, § 8, cl. 3. But it has been settled for more than a century that the Clause prohibits States from taking certain actions respecting interstate commerce even absent congressional action.

The principal objects of Commerce Clause scrutiny are statutes that discriminate against interstate commerce. Dynamics contends that the statute is discriminatory because it will apply most often to out-of-state entities. This argument rests on the contention that, as a practical matter, most hostile tender offers are launched by offerors outside Indiana. But this argument avails Dynamics little. . . . Because nothing in the Indiana Act imposes a greater burden on out-of-state offerors than it does on similarly situated Indiana offerors, we reject the contention that the Act discriminates against interstate commerce. . . .

Every State in this country has enacted laws regulating corporate governance. By prohibiting certain transactions, and regulating others, such laws necessarily affect certain aspects of interstate commerce. . . . . It thus is an accepted part of the business landscape in this country for States to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares. A State has an interest in promoting stable relationships among parties involved in the corporations it charters, as well as in ensuring that investors in such corporations have an effective voice in corporate affairs.

There can be no doubt that the Act reflects these concerns. The primary purpose of the Act is to protect the shareholders of Indiana corporations. It does this by affording shareholders, when a takeover offer is made, an opportunity to decide collectively whether the resulting change in voting control of the corporation, as they perceive it, would be desirable. A change of management may have important effects on the shareholders' interests; it is well within the State's role as overseer of corporate governance to offer this opportunity. The autonomy provided by allowing shareholders collectively to determine whether the takeover is advantageous to their interests may be especially beneficial where a hostile tender offer may coerce shareholders into tendering their shares. . . .

In our view, the possibility of coercion in some takeover bids offers additional justification for Indiana's decision to promote the autonomy of independent shareholders.

Dynamics' argument that the Act is unconstitutional ultimately rests on its contention that the Act will limit the number of successful tender offers. There is little evidence that this will occur. But even if true, this result would not substantially affect our Commerce Clause analysis. . . . Accordingly, even if the Act should decrease the number of successful tender offers for Indiana corporations, this would not offend the Commerce Clause.

IV

On its face, the Indiana Control Share Acquisitions Chapter evenhandedly determines the voting rights of shares of Indiana corporations. The Act does not conflict with the provisions or purposes of the Williams Act. To the limited extent that the Act affects interstate commerce, this is justified by the State's interests in defining the attributes of shares in its corporations and in protecting shareholders. Congress has never questioned the need for state regulation of these matters. Nor do we think such regulation offends the Constitution. Accordingly, we reverse the judgment of the Court of Appeals.

It is so ordered.

IV. Franchises

PAUL F. RAINEY et al. v. DOMINO'S PIZZA, LLC, EDWARD A. LANGEN, et al.

SUPREME JUDICIAL COURT OF MAINE

2010 ME 56; 998 A.2d 342

June 29, 2010, Decided

JUDGES: Panel: SAUFLEY, C.J., and ALEXANDER, LEVY, SILVER, MEAD, GORMAN, and JABAR, JJ.

OPINION BY: JABAR, J.

Paul F. and Patricia A. Rainey appeal from a partial summary judgment entered in the Superior Court (Cumberland County, *Warren, J.*) in favor of Domino's Pizza, LLC on the Raineys' claims for vicarious liability and negligence. The Raineys argue that the summary judgment record compels a conclusion that Domino's Pizza is vicariously liable for injuries Paul sustained in a motor vehicle accident. Alternatively, the Raineys contend that disputed issues of material fact remain regarding Domino's Pizza's vicarious liability. We affirm.

I. BACKGROUND

On July 25, 2004, while riding his motorcycle, Paul was seriously injured in a collision with a car driven by Edward A. Langen, who was delivering pizza for his employer, TDBO, Inc. TDBO is a Domino's Pizza franchisee that operates a Domino's Pizza franchise store in Gorham.

At the time of the accident, the relationship between TDBO and Domino's Pizza was governed pursuant to a "Standard Franchise Agreement" (Agreement) and "Manager's Reference Guide" (Guide). The following details of this contractual relationship are undisputed: (1) other than Domino's Pizza's right to receive royalties (5.5% of TDBO sales), there is no profit-sharing or loss-sharing and Domino's Pizza owns no interest in TDBO; (2) the entities share no common officers, directors, employees, or owners; (3) TDBO owns or leases its own equipment, and may "purchase items meeting [Domino's Pizza's] specifications from any source"; (4) TDBO maintains its own bank account, possesses its own tax identification number, business license, and operating permit, files separate tax returns, and pays the taxes it incurs as a result of its business operations; (5) TDBO establishes the prices for the products it sells and the wages it pays its employees; (6) Domino's Pizza does not specify or control the scheduling of TDBO's employees, except that it requires at least one qualified delivery driver to be present during store hours; and (7) other than mandating certain standards pursuant to the Agreement and Guide, Domino's Pizza does not hire, fire, train, pay, supervise, or discipline TDBO's employees.

Although the Raineys and Domino's Pizza disagree as to the significance of many of the contractual provisions governing the franchise relationship, viewed in the light most favorable to the Raineys, as the nonprevailing party, the record references in the parties' statements of material facts reveal the following about the Agreement and Guide.

The Agreement creates a uniform system of standards to ensure that each franchisee offers products and services that meet minimum criteria. Among the topics covered by the Agreement are food preparation, store location, royalty fees, training, advertising, recordkeeping, and insurance. Specifically, the Agreement provides that TDBO's franchise store "shall at all times be under the direct, on-premises supervision" of TDBO. . . . Domino's Pizza retains the right to "conduct reasonable inspections" of franchise stores, and reserves the power to terminate a franchise for certain violations, including failure to comply with provisions contained in the Agreement.

Regarding the franchise relationship, the Agreement disavows the existence of any agency relationship, and states that "[t]he parties to this Agreement are independent contractors and no training, assistance or supervision which [Domino's Pizza] may give or offer to [TDBO] shall be deemed to negate such independence or create a legal duty on [Domino's Pizza's] part."

By reference, the Agreement incorporates the Guide, a manual containing most of the detailed operational requirements. The Guide provides that "franchisees are solely responsible for the terms and conditions of employment applicable to their team members."

Section 12 of the Guide sets forth rules applicable to delivery drivers and delivery vehicles, including: (1) age limits for hiring drivers; (2) minimum motor vehicle record requirements; (3) seat belt usage requirements; (4) radar detector and cell phone usage limitations; and (5) delivery vehicle inspection and maintenance standards. Domino's Pizza also retains the right to "prescribe from time to time the boundaries beyond which the franchisee may not offer delivery service," and requires that franchisees "strictly comply with all laws, regulations and rules of the road and due care and caution in the operation of delivery vehicles."

In October 2007, the Raineys filed a complaint in the Superior Court against Langen, TDBO, and Domino's Pizza, alleging negligence, vicarious liability, and loss of consortium. Domino's Pizza moved for a summary judgment in April 2008, seeking judgment in its favor on the negligence and vicarious liability counts of the Raineys' complaint. The Raineys opposed the motion, arguing that disputed issues of fact existed as to whether Domino's Pizza exerted sufficient control over TDBO's operations to subject itself to vicarious liability for Langen's negligence.

On January 5, 2009, the court granted Domino's Pizza's motion. . . . The Raineys then brought this appeal.

II. DISCUSSION

We are called upon in this case to determine the circumstances in which a franchisor may be held vicariously liable for the negligent acts of an employee of its franchisee. Although the issue of franchisor vicarious liability is one of first impression in Maine, we are not without guidance. Principles of vicarious liability are well established in our state, and provide a suitable framework for analyzing the franchisor-franchisee relationship.

Stated generally, vicarious liability is "liability that a supervisory party (such as an employer) bears for the actionable conduct of a subordinate or associate (such as an employee) because of the relationship between the two parties." Because an employer may be held vicariously liable for the negligence of its employees, but is not usually responsible for the negligence of independent contractors, a prerequisite to imposing vicarious liability is the existence of an employer-employee relationship.

In distinguishing between employees and independent contractors, we consider several factors,[4] the most important of which is the "right to control." The right to control "includes the rights both to employ and to discharge subordinates and the power to control and direct the details of the work." On this point, we have emphasized that the right to control the "details of the performance," which is indicative of an employer-employee relationship, "must be distinguished from the right to control the result to be obtained, usually found in independent contractor relationships."

These principles apply with equal force in the franchisor-franchisee context. With near uniformity, courts apply some version of the "right to control" test in determining whether the imposition of vicarious liability on a franchisor is appropriate. . . . . This distinction is consistent with our emphasis on the "power to control and direct the details of the work," rather than the "result to be obtained."

4 In determining whether an independent contractor relationship exists, we have enumerated the following eight factors to be considered and weighed:

(1) the existence of a contract for the performance by a person of a certain piece or kind of work at a fixed price;

(2) independent nature of the business or his distinct calling;

(3) his employment of assistants with the right to supervise their activities;

(4) his obligation to furnish necessary tools, supplies, and materials;

(5) his right to control the progress of the work except as to final results;

(6) the time for which the workman is employed;

(7) the method of payment, whether by time or by job;

(8) whether the work is part of the regular business of the employer.

This distinction takes on an increased level of significance in claims of franchisor vicarious liability because of certain characteristics unique to the franchisor-franchisee relationship. "Generally, franchising is a method of expanding a business by licensing independent businessmen to sell the franchisor's product or service or to follow a format and trade style created by the franchisor using the franchisor's trade marks and trade names." Indeed, at its core, the franchise system involves the licensing of intellectual property, usually in the form of the franchisor's

trademark. The franchisor-franchisee relationship is thus heavily influenced by rules of trademark law, primarily as set forth in the Lanham Act.

Among other requirements, "the Lanham Act places an affirmative duty upon a licensor of a registered trademark to take reasonable measures to detect and prevent misleading uses of his mark by his licensees or suffer cancellation of his federal registration." . . . Accordingly, in order to avoid non-compliance with the Lanham Act, a trademark licensor has an obligation to maintain adequate control over the use of its mark.

Notwithstanding this resemblance to the vicarious liability "right to control" test, the control mandated by the Lanham Act was not intended to "saddle [a] licensor with the responsibilities under state law of a principal for his agent." As a result, it is necessary to evaluate the franchise relationship in light of the franchisor's duty to police its trademark.

Mindful of this concern, a number of courts have adopted a modified version of the vicarious liability "right to control" test. . . Other courts apply the traditional "right to control" test in analyzing franchisor vicarious liability. This approach recognizes that, while the vicarious liability and Lanham Act analyses involve an element of "control," the inquiries are distinct. To protect its trademark, a franchisor "must retain sufficient control over the licensees' dealings in the *end product* to insure that they will apply the mark to either the same product or to one of substantially the same quality with which the public in the past has associated the product." We conclude that the traditional approach strikes an appropriate balance. The traditional test allows a franchisor to regulate the uniformity and the standardization of products and services without risking the imposition of vicarious liability. If a franchisor takes further measures to reserve control over a franchisee's performance of its day-to-day operations, however, the franchisor is no longer merely protecting its mark, and imposing vicarious liability may be appropriate.

We now turn to the instant case. We review the Superior Court's grant of summary judgment de novo, considering "the evidence in the light most favorable to the nonprevailing party to determine whether the parties' statements of material facts and the record evidence to which the statements refer demonstrate that there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law."

To focus the discussion, a preliminary issue warrants explanation. In granting Domino's Pizza's summary judgment motion, the Superior Court considered the relevant issue to be whether Domino's Pizza "controlled or had the right to control Edward Langen." Although the Raineys seek to hold Domino's Pizza vicariously liable for the negligent acts of Langen, the proper focus of the analysis is on the relationship between Domino's Pizza and TDBO. If TDBO is an agent-employee of Domino's Pizza, then Langen, as an employee of TDBO, is also an agent-employee of Domino's Pizza. Based on our review of the Agreement and Guide, we conclude that, although the quality control requirements and minimum operational standards are numerous, these controls fall short of reserving control over the performance of TDBO's day-to-day operations. . . .

The Agreement specifies that the supervision and operation of the Gorham franchise store is TDBO's "sole responsibility" and that "it is not [Domino's Pizza's] responsibility or duty" to implement employee training programs. Moreover, though bound by certain mandated minimum requirements, TDBO: (1) determines the wages it pays its employees; (2) determines the scheduling of its employees; and (3) makes all day-to-day decisions concerning hiring, firing, training, supervising, and disciplining its employees. Although Domino's Pizza retains the right to conduct inspections and terminate the franchise relationship, such conditions do not constitute sufficient control to impose vicarious liability. . . .

Several other factors are inconsistent with an employer-employee relationship: (1) franchising, by its nature, typically involves the licensing of "independent businessmen to sell the franchisor's product or service;" (2) TDBO is responsible for purchasing or leasing its own equipment and supplies; and (3) Domino's Pizza does not compensate TDBO as its employee; rather, TDBO is paid by its customers and provides Domino's Pizza with a royalty fee.

In the end, the quality, marketing, and operational standards present in the Agreement and Guide do not establish the supervisory control or right of control necessary to impose vicarious liability. Because we conclude that, as a matter of law, Domino's Pizza did not retain sufficient control over TDBO so as to subject itself to vicarious liability, the court did not err in granting Domino's Pizza's motion for summary judgment.

The entry is: Judgment affirmed.

RAYMOND R. MARTIN, SR., et al., Co-administrators of the Estate of Laura Martin, Deceased, et al., Plaintiffs-Appellees, v. McDONALD'S CORPORATION et al., Defendants-Appellants (Maureen Kincaid et al., Plaintiffs-Appellees)

Appellate Court of Illinois, First District, Fifth Division

213 Ill. App. 3d 487; 572 N.E.2d 1073

May 3, 1991

JUDGES: Justice McNulty delivered the opinion of the court. Lorenz, P.J., and Murray, J., concur.

OPINION BY: JUSTICE McNULTY delivered the opinion of the court:

This case involves an appeal by McDonald's Corporation from judgments in favor of plaintiffs Raymond R. Martin, Sr., Marianne Martin, Maureen Kincaid and Therese Dudek. The trial court awarded damages in the amount of $1,003,445.37 to Raymond R. Martin, Sr., and Marianne Martin for the wrongful death of their daughter, Laura Martin. It also awarded damages of $125,000 each to Maureen Kincaid and Therese Dudek for the negligent infliction of emotional distress. McDonald's appeals not only the judgment of the trial court awarding damages to the plaintiffs, but also the denial of its post-trial motion for judgment notwithstanding the verdict.

This case arose from a murder and robbery which took place after closing hours of the McDonald's restaurant in Oak Forest, Illinois, late in the evening of November 29, 1979. On that evening, a six-woman teenaged crew was working to clean up and close the restaurant; Laura Martin, Therese Dudek and Maureen Kincaid were members of that crew. A person later identified as Peter Logan appeared in the back of the restaurant and ordered the crew into the refrigerator and the assistant manager, Therese Dudek, to open the safe and get him money. In the course of moving the crew into the refrigerator, Laura Martin was shot and killed, and Maureen Kincaid and Therese Dudek were assaulted by Logan. Laura Martin's parents claimed damages from McDonald's Corporation for the wrongful death of their daughter, and Therese Dudek and Maureen Kincaid claimed damages for the negligent infliction of emotional distress. The trial court awarded damages to all three victims, and McDonald's Corporation appealed.

NEGLIGENCE CLAIMS

In order for plaintiffs to recover on a theory of negligence, they must establish that there was a duty owed to them by defendant, that defendant breached its duty, that they were injured, and that defendant's breach of duty or negligence was the proximate cause of their injuries. The question of duty, the legal obligation imposed upon one for the benefit of another, is a question of law to be determined by the court.

Defendant, McDonald's Corporation, contends that it had no duty to protect Laura Martin, Maureen Kincaid or Therese Dudek since it was merely the licensor of the business that was operated by McDonald's Restaurants of Illinois, and plaintiffs were employees of the licensee. McDonald's asserts that it had no duty to plaintiffs, as it had no "special relationship" (such as common carrier/passenger, innkeeper/guest, possessor of land/member of the public, or one who has custody of another who is deprived of the opportunity to protect himself) with them as required by section 314 of the Restatement (Second) of Torts (1965).

Plaintiffs, however, do not ask this court to determine that defendant McDonald's owed them a duty of care because it had a special relationship to them. Rather, they insist that McDonald's owed them a duty of care and protection because it had voluntarily assumed such a duty. Case law supports the proposition that liability can arise from the negligent performance of a voluntary undertaking.

The negligent performance of a voluntary undertaking has also been used as a basis for imposing liability in two Illinois landlord-tenant cases. . . . The failure to properly complete or to carry out an assumed duty imposes liability in the same manner as for dangers affirmatively created during the course of the assumed undertaking.

Plaintiffs argue that McDonald's . . . had assumed an increased responsibility for their care and protection, and as such, was liable for the negligent performance of this voluntary undertaking. Even though McDonald's had no duty imposed by law to protect plaintiffs against the criminal acts of third parties, it had voluntarily recognized the threat

of armed robbery and the importance of security in the restaurants, especially in the time period immediately after closing. It had created a branch of its corporation assigned to deal with security problems and had prepared a bible for store security operations. McDonald's, through its regional security manager, Jim Carlson, undertook not only the obligation to check for security problems, but also to communicate to the store management what the security policies were and to "follow-up" to be certain that the problems had been corrected and the "recommended" security procedures "followed."

Defendant urges the court to consider the separate and distinct nature of McDonald's Corporation and McDonald's Restaurants of Illinois, Inc. It asserts that McDonald's Corporation was only the licensor of a business that was operated by McDonald's Restaurants, Inc., and that McDonald's Restaurants, Inc., was the employer of the plaintiffs. Even though all this is in fact true, it only goes to the legal relationship of McDonald's Corporation to the plaintiffs. No matter what legal relationships existed, it was McDonald's Corporation which undertook to provide security and protection to plaintiffs.

It was McDonald's Corporation's regional security manager, Jim Carlson, who acted directly as security supervisor for the newly acquired Oak Forest McDonald's, even though this restaurant was directly owned by McDonald's Restaurants of Illinois, Inc. Since McDonald's Restaurants of Illinois had neither an operations manager nor a security supervisor, these positions were handled by Steve Zdunek and James Carlson, two executives from defendant McDonald's Corporation.

On October 31, 1979, both Carlson and Zdunek visited the Oak Forest store. Carlson met with the store manager, Karl Ferret, and although he did not provide Ferret with a copy of the McDonald's bible of security procedures which Carlson had written, he did inform Ferret about McDonald's proper closing procedures, specifically stating that no one should go out or throw garbage out the back door after dark. Trash or grease were to be taken out the side glass door at least one hour prior to closing by one employee while another watched from inside. This was required as part of McDonald's security policy to thwart entry by an unauthorized person into the store. During this visit to the store, Carlson also did a security check, and made certain security changes which included changing locks and ordering a new security window and Detex alarm system for the back door.

The trial court correctly determined that McDonald's Corporation had a duty to protect plaintiffs Laura Martin, Maureen Kincaid and Therese Dudeck from harm. Although it did not specifically state that such duty was "assumed," there is ample support in case law and the facts of this case to support a determination that McDonald's Corporation voluntarily assumed a duty to provide security to plaintiffs and protect them from harm.

Once McDonald's Corporation assumed the duty to provide security and protection to plaintiffs, it had the obligation to perform this duty with due care and competence, and any failure to do so would lead to a finding of breach of duty. While McDonald's argues that the duty it assumed was only to inspect and warn, the testimony of its regional security manager, Jim Carlson, and its operations manager, Steve Zdunek, reveals that the duty assumed included follow-up in addition to inspection and warning in order to be sure that security policies were being carried out. Both Zdunek and Carlson also testified that neither one of them followed up. Although they acknowledged that back door security was crucial, Carlson had not visited the store since the take-over, and while Zdunek had visited the store several times for the purposes of ensuring that operations conformed to McDonald's manuals as far as cleanliness, appearance of the crew, preparation of food, etc., he admitted that he was never there at night to see that proper closing procedures were being followed. Even if there was not sufficient time between the take-over and the armed robbery to order, receive and install the security window and the Detex alarm system, there certainly was time to make an on-site evening inspection to be sure that proper closing procedures were being followed, and that the primarily teenaged work force was properly instructed as to closing procedures. Yet neither Zdunek nor Carlson ever checked to be sure that the back door was not being used after dark or that signs were posted on the door warning employees not to use this door after dark. Neither checked to be sure that the primarily teenaged work crews received proper instructions about the use of the back door. In fact, several of the employees testified that they had never received a security manual, had never seen warning signs on the back door, and had never been instructed not to use the back door after dark. Furthermore, neither Zdunek nor Carlson had ever noticed the dumpster that was pulled up to the back door after dark so that employees could dump garbage simply by opening the back door.

Thus, McDonald's clearly established a security policy which unquestionably included a follow-up. Nevertheless, its key security people, Carlson and Zdunek, admittedly failed to follow up. McDonald's argument that the employees were already familiar with security procedures and did not need to be instructed is belied by the facts of the actual operation of the restaurant. Trial testimony proved that the work crew used the back door exclusively, both before and after dark, and emptied garbage and grease through this door all day and all night. A dumpster was brought to

the rear door of the restaurant at night to facilitate garbage removal. Failure to empty grease at night would result in a reprimand to employees. In view of this established operating procedure, it is meaningless for McDonald's to argue that employees were familiar with back door security and that a follow-up was unnecessary. Therefore, the duty which McDonald's defined for itself included a follow-up which was doubly necessary because of the operating conditions of the restaurant. Accordingly, there was ample evidence for the jury to determine that McDonald's had breached its assumed duty to plaintiffs.

McDonald's argues that even if it had and breached a duty to plaintiffs, there is no evidence to support the contention that anything McDonald's Corporation did or failed to do was the proximate cause of the entry of Logan onto the premises and the subsequent injury to the plaintiffs. . . . The instant action is dissimilar to the cited authority in that there is a great deal of circumstantial evidence from which the jury could conclude that defendant's actions were a proximate cause of plaintiffs' injuries. Rebecca Snella, a 17-year-old employee of the Oak Forest McDonald's, testified that she was in charge of doing dishes the night of the armed robbery. The sink where she was working was on the same wall as the rear door. There was also a bathroom door within four feet of where she was working. Although Rebecca did not watch the bathroom door all night, she testified that she would have been aware of someone coming from that door. While she did not see Peter Logan (the robber) come through the back door, she stated that he approached her from the rear of the store. Logan himself testified that though he was under the influence of drugs and could not remember much about the evening, he did remember that he was attracted by the light over the back door. Moreover, Logan had been convicted of another robbery of a McDonald's in Alsip three months earlier. There was conflicting testimony at trial about whether the earlier robbery involved an employee taking garbage out the back door after closing. There was also conflicting testimony about whether the rear door in the Oak Forest McDonald's latched properly, and evidence that it had been opened at least twice after closing, once when employee Janet Brown went home, and again when Rebecca Snella emptied the garbage. While it is true that there is no direct evidence that Peter Logan entered the store through the rear door, there is more than ample circumstantial evidence on which the jury could conclude that Logan did indeed gain entry to the McDonald's through the rear door and that the failure of McDonald's security procedures facilitated that entry and were thus the proximate cause of injury to plaintiffs.

Plaintiffs Maureen Kincaid and Therese Dudek were direct victims of an assault and battery perpetrated by Peter Logan and proximately caused by defendant McDonald's negligence. Furthermore, both plaintiffs suffered lingering physical manifestations of their emotional distress. Both became depressed and withdrew from family and friends. Maureen Kincaid developed a fear of going out at night, became afraid to remain in her own home, and even contracted severe intestinal problems leading to a diagnosis of ulcerative colitis. Therese Dudek suffered from insomnia for a period of at least two years and could not eat regular meals. Both plaintiffs sought treatment from a counselor to help them deal with their problems.

Maureen Kincaid and Therese Dudek suffered the physical impact of Logan's gun. Moreover, they were direct victims not only of Logan's assault and battery, but also of McDonald's negligence. . . . Furthermore, this factual setting, which involves both negligence, murder, assault and battery, is so unique as to be unlikely to pave the way for future frivolous allegations of emotional distress. Thus, for these reasons and based on the facts of this case, we find that plaintiffs Maureen Kincaid and Therese Dudek have stated a valid claim for the negligent infliction of emotional distress and are entitled to damages recognizable under the law. . . .

Thus, we find that there was no trial court error which would entitle defendant to a judgment notwithstanding the verdict, or in the alternative, a new trial. We affirm the trial court's determination of defendant McDonald's negligence and its award of damages to the parents of Laura Martin for their daughter's wrongful death, and to Maureen Kincaid and Therese Dudek for the negligent infliction of emotional distress.

Judgment affirmed.

LORENZ, P.J., and MURRAY, J., concur.

RONALD CISLAW et al., Plaintiffs and Appellants, v. SOUTHLAND CORPORATION, Defendant and Respondent.

Court of Appeal of California, Fourth Appellate District

4 Cal. App. 4th 1284; 6 Cal. Rptr. 2d 386

March 25, 1992, Decided

JUDGES: Opinion by Sonenshine, J., with Sills, P. J., and Moore, J., concurring.

Ronald and Carole Cislaw appeal from a summary judgment entered in favor of The Southland Corporation in this action arising out of the alleged wrongful death of their son, Timothy. The Cislaws contend the court erred in deciding Southland was not vicariously liable for the sale of clove cigarettes from a franchised 7-Eleven store. They argue the evidence gave rise to conflicting inferences, requiring a jury determination of employment, agency, partnership and joint venture issues.

I

Timothy Cislaw, 17 years old, died of respiratory failure on May 10, 1984. His parents filed a wrongful death action alleging Timothy's death resulted from his use of Djarum Specials clove cigarettes sold at a Costa Mesa 7- Eleven store. Southland owns the 7-Eleven trademark and is the franchisor of California 7-Eleven stores. The Costa Mesa 7-Eleven was franchised to Charles Trujillo and Patricia Colwell-Trujillo. The complaint, seeking compensatory and punitive damages, stated causes of action for negligence, breach of implied and express warranty, product liability and infliction of emotional distress.

After answering the complaint, Southland moved for summary judgment asserting (1) it had no direct liability for Timothy's death, and (2) it had no vicarious liability based on the Trujillos' conduct because, as franchisees of the 7-Eleven store, the Trujillos were independent contractors as a matter of law. In support of its motion, Southland presented the declarations of Colwell-Trujillo and a Southland management employee, Arthur Salcido, both of whom attested to facts indicating the franchisees were independent contractors. Southland further relied upon the franchise agreement itself to negate any issue of agency.

The Cislaws neither interposed evidentiary objections to Southland's declarations nor presented controverting evidence. Rather, they relied solely on the franchise agreement, asserting it could be interpreted to demonstrate an employment or agency relationship. The trial court, asked to make a legal determination on uncontradicted facts, decided as a matter of law the Trujillos were independent contractors and granted Southland's motion for summary judgment.

We must decide whether the franchise agreement and uncontroverted declarations establish that the Trujillos acted as independent contractors when they sold the clove cigarettes. Before turning to the evidence presented to the trial court, we briefly review the law of agency in the context of franchises.

II

Franchising is a heavily regulated form of business in California, but there are relatively few decisions on the nature of the relationship between franchisor and franchisee as it affects third persons. The general rule is where a franchise agreement gives the franchisor the right of complete or substantial control over the franchisee, an agency relationship exists.

In the 1960's, the appellate courts decided three Arthur Murray Dance Studio franchise agreement cases. . . . In the second case, the reviewing court affirmed a judgment against the franchisor on an actual agency basis. The franchisor had retained controls " 'extending beyond those necessary to protect and maintain its trade mark, trade name and good will, and cover[ing] day to day details of the San Diego studio's operation.' " The franchise agreement gave the franchisor virtually absolute control of the enterprise. It allowed the franchisor: (1) to handle every aspect of employment; (2) to determine rates to be charged for lessons and whether or not to refund money to pupils; (3) to choose the lenders with whom pupil contracts would be financed; (4) to control all advertising, which the franchisee was required to submit for prior approval; (5) to compel the franchisee to honor unused dance lessons purchased at a

different studio, without compensation; and (6) to cancel the franchise agreement immediately upon its determination that the franchisee was not conducting the studio in accordance with " 'the general policies of the [franchisor] as established from time to time.' "

The evidence was sufficient to support the trial court's conclusion that the franchisee acted as the franchisor's agent in dealings with third persons. . . .

After the Arthur Murray decisions came *Wickham* v. *Southland Corp*. There, plaintiffs claimed the franchisor, Southland, was liable for their decedent's death, allegedly caused by a 7- Eleven store's sale of alcoholic beverages to an intoxicated minor. The jury found by special verdict there was no agency relationship on which to predicate the franchisor's liability. On appeal, plaintiffs contended the jury should have been instructed that an agency relationship exists as a matter of law if a franchisor can exercise *substantial* control over the business operations of the franchisee.

The reviewing court rejected that argument, stating a principal-agency relationship exists as a matter of law only when the franchisor can exercise *complete* control; otherwise, "the right to control [is] an important factor to be taken into consideration along with the ... other factors enumerated." . . . The court concluded: "The right to control *the result* is inherent in both independent contractor relationships and principal-agency relationships; it is the right to control the means and manner in which the result is achieved that is significant in determining whether a principal-agency relationship exists. . . .

The cases, taken as a whole, impliedly recognize that the franchisor's interest in the reputation of its entire system allows it to exercise certain controls over the enterprise without running the risk of transforming its independent contractor franchisee into an agent.

III

We examine Southland's evidence on the issue of agency in light of the above decisions. Where, as here, the party opposing summary judgment has filed no counter-declarations, the moving party still has the burden of establishing evidentiary facts demonstrating its entitlement to judgment.

Colwell-Trujillo said that, as provided under the franchise agreement, she exercised "full and complete control over" the store's employees and "any and all labor relations," including "hiring, firing, disciplining, compensation ... and work schedules." She attested, "I could purchase whatever inventory I chose and from whomever I wanted and I did so." She decided how much of any particular item to order, how frequently to order it, and what to charge for it. Colwell-Trujillo stated, "Southland had no control over my decision to sell or not sell clove cigarettes at the store. It was my sole decision to sell clove cigarettes. I alone set the prices. In no way did Southland ever advertise, promote or merchandize [*sic*] the clove cigarettes sold in my store."

Colwell-Trujillo said she "paid all operating expenses" and made "all operational decisions." She alone was responsible for "the posting of any warnings and compliance with licenses, local, state and federal ordinances, regulations, statutes and other laws.". . .

Salcido further stated, "Southland receives a monthly payment of a 7- Eleven charge" from the franchisee, but it "does not participate in the [store's] net profits or losses." "Southland does not and has not ever manufactured, ... distributed, ... recommended, merchandised, advertised, promoted or sold clove cigarettes. Southland has never recommended that clove cigarettes be sold at the Trujillo store, has never asked the Trujillos to sell clove cigarettes, or set the prices of the clove cigarettes sold in the Trujillo store." Salcido said Southland was without power to prevent the Trujillos from selling clove cigarettes. Southland had never received a complaint about clove cigarettes, the Trujillos or their employees prior to the Cislaws' action.

The 16-page, single-spaced, fine print franchise agreement. . . recites that the franchisees are independent contractors, and two provisions give the Trujillos the right to make all inventory, employment and operational decisions.

Does the above evidence create a triable issue of fact that Southland had the all-important right to control the means and manner in which the Trujillos achieved the result? We think not. Colwell-Trujillo attested she had the right to exercise, and actually exercised, "full and complete control" over all employment, inventory and marketing decisions, including the decision to sell clove cigarettes. She said she paid all operating expenses, made "all operational decisions" and was responsible for seeing to it the Trujillos' store was in compliance with local, state and federal laws. Salcido agreed the Trujillos had "sole authority" to make employment and inventory decisions and Southland had no power to prevent them from selling the clove cigarettes. In addition, the franchise agreement did not require the franchisees to purchase

particular merchandise from particular vendors or to sell merchandise at suggested prices. It expressly gave the franchisees control over the manner and means of the store's operation, including the sole right to make all employment decisions. The evidence leads to the compelling conclusion that Southland did not control the means and manner. . . .

The above franchise agreements . . . withheld from the franchisor control over decisions relating to employment, inventory and day- to-day operations of the 7-Eleven store. For this reason, the agreement could not, in and of itself, provide a basis for finding the existence of an agency relationship between the Trujillos and Southland. . . .

We merely observe that once Southland established without controversy that (1) it did not control the means and manner in which the Trujillos ran the store, and (2) the agreement was not terminable at will, nothing more was necessary. The Cislaws were not entitled to proceed to trial on their agency theory.

IV

We briefly address the Cislaws' half-hearted contention that triable issues of fact exist as to a partnership or joint venture theory of recovery. . . .

The Cislaws base their argument regarding partnership or joint venture on Southland's purported right to share profits of the 7-Eleven store with the Trujillos. Salcido attested the Trujillos paid a monthly 7-Eleven franchise fee to Southland, consisting of a percentage of the total sales receipts after deduction of cost of goods sold. Salcido stated Southland did not participate in the store's net profits or losses. The franchise agreement bears this out.

There is no evidence showing Southland and the Trujillos shared the profits and losses of the enterprise. And, as we have discussed at length, nothing in the record demonstrates Southland has the right to joint management and control of the business. The Cislaws were not entitled to try the case on a theory of partnership or joint venture.

Judgment affirmed. Respondent is to recover costs of appeal.

Sills, J. and Moore, J., concurred. Appellant's petition for review by the Supreme Court was denied June 10, 1992.

HOLIDAY INNS, INC., et al v. ROBERT SHELBURNE, et al v. G. JULIUS RICE, as Personal Representative of the Estate of DAVID LAMAR RICE, deceased, G. JULIUS RICE, individually and EVELYN RICE, individually, et al, Appellees/Cross Appellants

Court of Appeal of Florida, Fourth District

576 So. 2d 322

January 30, 1991, Filed

JUDGES: Hersey, C.J. Dell and Gunther, JJ., concur.

OPINION BY: Hersey

Appellants' motion for rehearing is granted and our original opinion is vacated and replaced by the following opinion.

These are two consolidated appeals from final judgments against appellants, defendants below, in two personal injury actions and a wrongful death action.

The injuries and the death resulted from an altercation between two groups of individuals who had been drinking at the Rodeo Bar in the Fort Pierce Holiday Inn.

One group was composed of the following couples: the Bennetts, the Smiths, the Carters, and the Parramores. The second group consisted of Robert Shelburne, Scott Turner, David Rice, Lisa Fuston, and others.

On the night of the incident the driver of the car carrying the latter group attempted to park at the Holiday Inn. A security guard prevented him from doing so. Consequently, he parked in the adjacent parking lot of Ingram's Fruit Stand, a business that was temporarily closed.

Both groups spent time in the Rodeo Bar, leaving at closing time. According to the record, as some individuals were moving toward their respective vehicles, they exchanged remarks and ultimately a fight erupted. The evidence shows that during the course of the physical combat Carter shot Turner, Rice, and Shelburne. Rice died from his wounds.

In the subsequent jury trial appellants were found liable and Turner was awarded $3,825,000 for his injuries, Shelburne received $1,000,000, and the Rice interests were awarded $1,000,000. The corporate defendants appeal. We turn our attention first to appellants' contention that they were entitled to a directed verdict.

A. DEFENDANTS' MOTION FOR DIRECTED VERDICT

Generally, the proprietor of a place of public entertainment owes an invitee a duty to use due care to maintain the premises in a reasonably safe condition commensurate with the activities conducted thereon. Although not an insurer of a patron's safety, the proprietor of a bar or saloon is bound to use every reasonable effort to maintain order among the patrons, employees, or those who come upon the premises and are likely to produce disorder to the injury or inconvenience of patrons lawfully in the place of business. The risk of harm must be foreseeable, and the determination of a breach of this duty depends on the facts of each individual case.

Appellants maintain that in order to impose a duty upon them, the appellees were required to prove that the appellants had actual or constructive knowledge of prior, similar criminal acts against invitees on their property. Appellants argue that they were not bound to anticipate criminal acts of third persons where, as in the present case, the wrongdoers were complete strangers to them and the victims, and the incident occurred precipitously and off appellants' property. Appellants point out that they are not insurers of the safety of appellees and as a matter of law are not liable for the consequences of Carter's criminal acts.

The Florida Supreme Court has held . . . that to impose liability on a tavern owner for injuries to patrons intentionally inflicted by third parties, the risk of harm to his patrons must be reasonably foreseeable.

The supreme court held that a tavern owner may be liable for injuries to its patrons caused by the tortious conduct of third parties only if the tavern owner knew or should have known of the dangerous propensities of that specific assailant. Foreseeability can be shown by proving that, based on past experience, a proprietor knew or should have

known of the likelihood of disorderly conduct by third persons in general which might endanger the safety of the proprietor's patrons.

The Florida Supreme Court stated:

> "A dangerous condition may be indicated if, according to past experience (i.e., reputation of the tavern), there is a likelihood of disorderly conduct by third persons in general which might endanger the safety of patrons or if security staffing is inadequate. These indicia are not exhaustive. If the lounge management knew or should have known of a general or specific risk and failed to take reasonable steps to guard against that risk and if, because of that failure, [a patron] was injured, [the tavern owner] may be shown to have breached its duty and may be held financially responsible for [the patron's] injuries."

Accordingly, appellants' argument that they were entitled to a directed verdict because appellees failed to produce evidence of the particular risk involved is without merit. . . . The conflicting evidence of the Rodeo Bar's inadequate security and fifty-eight police incident reports of problems at the Rodeo Bar, including crimes against persons within the past eighteen months, provided a basis for a finding of foreseeability and precluded a directed verdict.

2. Defense of Independent, Active, Efficient, Intervening Cause.

[discussion omitted]

3. Defense That Injury Occurred Off Premises.

[discussion omitted]

B. LIABILITY OF HOLIDAY INNS, INC.

We next turn to a consideration of appellate issues dealing with the relationships of the defendants to one another as those relationships impact upon the primary issue of negligence.

Holiday Inns, Inc. asserts that it was sued on liability through its apparent agents, the owners and operators of the bar. Holiday Inns, Inc. argues that it was entitled to a directed verdict or to a judgment notwithstanding the verdict.

Apparent Authority.

Appellees alleged in their complaint that Holiday Inns, Inc. was liable for the acts of its apparent agents, Hospitality Venture, Leisure Dynamics and Vista Management. In addition to liability for express or implied agency, a principal is also bound by acts and contracts which are within the apparent authority of its agent. The existence of an agency relationship is ordinarily a question to be determined by a jury in accordance with the evidence adduced at trial, and can be proven by facts and circumstances on a case-by-case basis.

The three elements needed to establish apparent agency, often referred to as agency by estoppel, are: (1) a representation by the principal; (2) reliance on that representation by a third person; and (3) a change of position by the third person in reliance upon such representation to his detriment. As Holiday Inns, Inc. correctly argues, all three elements must be proven before an apparent agency is established. Furthermore, the doctrine of apparent authority rests on appearances created by the principal, not the agent. Notwithstanding Holiday Inns, Inc.'s argument to the contrary, appellees produced evidence at trial which satisfied all three elements thereby precluding a directed verdict.

The facts in this case show that there was sufficient evidence for the jury reasonably to conclude that Holiday Inns, Inc. represented to the public that it could expect a particular level of service at the Fort Pierce Holiday Inn and at its bar. The hotel, restaurant, and bar were owned by Hospitality Venture (a joint venture between Vista Management and Leisure Dynamics), and managed by Vista Management. Hospitality Venture had entered into a license agreement or franchise with Holiday Inns, Inc. to operate not only the hotel, but also the restaurant and bar as part of the "Holiday Inns System." Holiday Inns, Inc. gave Hospitality Venture, the franchisee, use of the Holiday Inns, Inc. logo and made the franchisee part of the corporation's reservation system. In fact, Holiday Inns, Inc.'s standard sign was displayed in front of the Fort Pierce Holiday Inn in order to draw customers through name recognition. Clearly, this evidence shows that Holiday Inns, Inc. represented to the public that this particular hotel was a part of the national chain of Holiday Inns and that it could find a certain level of service (and safety) at its hotel and bar.

Holiday Inns, Inc. also argues that there is no evidence of appellees' reliance on Holiday Inns, Inc. ownership and operation of the Rodeo Bar, and therefore, P.D.R. is distinguishable from the present case. Holiday Inns, Inc. claims that appellees patronized the Rodeo Bar because of its urban cowboy atmosphere, rather than because it was part of a Holiday Inn complex.

However, there is evidence in the record from which a jury could have found that appellees had relied upon Holiday Inns, Inc.'s representations. Scott Turner testified that he had a sense of security and safety because the Rodeo Bar was at a Holiday Inn. Further, he stated that, "when you associate something with the Holiday Inn or Ramada Inn or something with a big name like that, you wouldn't think that you would have a rough place, they would let it, you know, have fights going on and all that kind of stuff . . . ."

Robbie Shelburne testified that the Rodeo Bar's location or placement in the Holiday Inn was significant to him. The Holiday Inn sign made him feel that "at a big place like that . . . even though it was a bar . . . everything is going to be okay . . . ."

Lisa Funston testified that she had been to the Rodeo Bar several times. She felt it was safe because, "it's a Holiday Inn. It's a hotel. There's more people around beside people just there in the bar . . . ." Generally, Holiday Inns have the reputation of being "a vacation place for families . . . ."

Clearly, on the question of reliance, the jury had a right to conclude that appellees believed exactly what Holiday Inns, Inc. wanted them to believe — that the Fort Pierce Holiday Inn and its Rodeo Bar were part of Holiday Inns' system. The evidence supported the jury's finding that Hospitality Venture, Vista Management, Inc., and Leisure Dynamics were the apparent agents of Holiday Inns, Inc. and were acting within the scope of their apparent authority.

Holiday Inns, Inc.'s liability was based on its vicarious liability for Hospitality Venture, Vista Management and Leisure Dynamics as its apparent agents. Further, the jury knew that a default had been entered against Friend's employer, Aristocrat Security, for negligence in using untrained security guards.

CONCLUSION

There are no errors, either individually or cumulatively, which require reversal of these final judgments. Therefore, we affirm. . . .

AFFIRMED.

V. Securities Law

SECURITIES & EXCHANGE COMMISSION v. W. J. HOWEY CO. ET AL.

Supreme Court of the United States

328 U.S. 293

May 27, 1946, Decided

JUDGES: Stone, Black, Reed, Frankfurter, Douglas, Murphy, Rutledge, Burton; Jackson took no part in the consideration or decision of this case.

MR. JUSTICE MURPHY delivered the opinion of the Court.

This case involves the application of § 2 (1) of the Securities Act of 1933 to an offering of units of a citrus grove development coupled with a contract for cultivating, marketing and remitting the net proceeds to the investor. The Securities and Exchange Commission instituted this action to restrain the respondents from using the mails and instrumentalities of interstate commerce in the offer and sale of unregistered and non-exempt securities in violation of § 5 (a) of the Act. The District Court denied the injunction. . . . We granted certiorari on a petition alleging that the ruling of the Circuit Court of Appeals conflicted with other federal and state decisions and that it introduced a novel and unwarranted test under the statute which the Commission regarded as administratively impractical.

Most of the facts are stipulated. The respondents, W. J. Howey Company and Howey-in-the-Hills Service, Inc., are Florida corporations under direct common control and management. The Howey Company owns large tracts of citrus acreage in Lake County, Florida. During the past several years it has planted about 500 acres annually, keeping half of the groves itself and offering the other half to the public "to help us finance additional development." Howey-in-the-Hills Service, Inc., is a service company engaged in cultivating and developing many of these groves, including the harvesting and marketing of the crops.

Each prospective customer is offered both a land sales contract and a service contract, after having been told that it is not feasible to invest in a grove unless service arrangements are made. While the purchaser is free to make arrangements with other service companies, the superiority of Howey-in-the-Hills Service, Inc., is stressed. Indeed, 85% of the acreage sold during the 3-year period ending May 31, 1943, was covered by service contracts with Howey-in-the-Hills Service, Inc.

The land sales contract with the Howey Company provides for a uniform purchase price per acre or fraction thereof, varying in amount only in accordance with the number of years the particular plot has been planted with citrus trees. Upon full payment of the purchase price the land is conveyed to the purchaser by warranty deed. Purchases are usually made in narrow strips of land arranged so that an acre consists of a row of 48 trees. During the period between February 1, 1941, and May 31, 1943, 31 of the 42 persons making purchases bought less than 5 acres each. The average holding of these 31 persons was 1.33 acres and sales of as little as 0.65, 0.7 and 0.73 of an acre were made. These tracts are not separately fenced and the sole indication of several ownership is found in small land marks intelligible only through a plat book record.

The service contract, generally of a 10-year duration without option of cancellation, gives Howey-in-the-Hills Service, Inc., a leasehold interest and "full and complete" possession of the acreage. For a specified fee plus the cost of labor and materials, the company is given full discretion and authority over the cultivation of the groves and the harvest and marketing of the crops. The company is well established in the citrus business and maintains a large force of skilled personnel and a great deal of equipment, including 75 tractors, sprayer wagons, fertilizer trucks and the like. Without the consent of the company, the land owner or purchaser has no right of entry to market the crop; thus there is ordinarily no right to specific fruit. The company is accountable only for an allocation of the net profits based upon a check made at the time of picking. All the produce is pooled by the respondent companies, which do business under their own names.

The purchasers for the most part are non-residents of Florida. They are predominantly business and professional people who lack the knowledge, skill and equipment necessary for the care and cultivation of citrus trees. They are attracted by the expectation of substantial profits. It was represented, for example, that profits during the 1943-1944 season amounted to 20% and that even greater profits might be expected during the 1944-1945 season, although only a 10% annual return was to be expected over a 10-year period. Many of these purchasers are patrons of a resort hotel owned

and operated by the Howey Company in a scenic section adjacent to the groves. The hotel's advertising mentions the fine groves in the vicinity and the attention of the patrons is drawn to the groves as they are being escorted about the surrounding countryside. They are told that the groves are for sale; if they indicate an interest in the matter they are then given a sales talk.

It is admitted that the mails and instrumentalities of interstate commerce are used in the sale of the land and service contracts and that no registration statement or letter of notification has ever been filed with the Commission in accordance with the Securities Act of 1933 and the rules and regulations thereunder.

Section 2 (1) of the Act defines the term "security" to include the commonly known documents traded for speculation or investment.[1] This definition also includes "securities" of a more variable character, designated by such descriptive terms as "certificate of interest or participation in any profit-sharing agreement," "investment contract" and "in general, any interest or instrument commonly known as a 'security.'" The legal issue in this case turns upon a determination of whether, under the circumstances, the land sales contract, the warranty deed and the service contract together constitute an "investment contract" within the meaning of § 2 (1). An affirmative answer brings into operation the registration requirements of § 5 (a), unless the security is granted an exemption under § 3 (b). The lower courts, in reaching a negative answer to this problem, treated the contracts and deeds as separate transactions involving no more than an ordinary real estate sale and an agreement by the seller to manage the property for the buyer.

The term "investment contract" is undefined by the Securities Act or by relevant legislative reports. But the term was common in many state "blue sky" laws in existence prior to the adoption of the federal statute and, although the term was also undefined by the state laws, it had been broadly construed by state courts so as to afford the investing public a full measure of protection. Form was disregarded for substance and emphasis was placed upon economic reality. An investment contract thus came to mean a contract or scheme for "the placing of capital or laying out of money in a way intended to secure income or profit from its employment." . . . . This definition was uniformly applied by state courts to a variety of situations where individuals were led to invest money in a common enterprise with the expectation that they would earn a profit solely through the efforts of the promoter or of some one other than themselves.

By including an investment contract within the scope of § 2 (1) of the Securities Act, Congress was using a term the meaning of which had been crystallized by this prior judicial interpretation. It is therefore reasonable to attach that meaning to the term as used by Congress, especially since such a definition is consistent with the statutory aims. In other words, an investment contract for purposes of the Securities Act means 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 the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise. . . . .

The transactions in this case clearly involve investment contracts as so defined. The respondent companies are offering something more than fee simple interests in land, something different from a farm or orchard coupled with management services. They are offering an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by respondents. They are offering this opportunity to persons who reside in distant localities and who lack the equipment and experience requisite to the cultivation, harvesting and marketing of the citrus products. Such persons have no desire to occupy the land or to develop it themselves; they are attracted solely by the prospects of a return on their investment. Indeed, individual development of the plots of land that are offered and sold would seldom be economically feasible due to their small size. Such tracts gain utility as citrus groves only when cultivated and developed as component parts of a larger area. A common enterprise managed by respondents or third parties with adequate personnel and equipment is therefore essential if the investors are to achieve their paramount aim of a return on their investments. Their respective shares in this enterprise are evidenced by land sales contracts and warranty deeds, which serve as a convenient method of determining the investors' allocable shares of the profits. The resulting transfer of rights in land is purely incidental.

Thus all the elements of a profit-seeking business venture are present here. The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise. It follows that the arrangements

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[3] "The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

whereby the investors' interests are made manifest involve investment contracts, regardless of the legal terminology in which such contracts are clothed. The investment contracts in this instance take the form of land sales contracts, warranty deeds and service contracts which respondents offer to prospective investors. And respondents' failure to abide by the statutory and administrative rules in making such offerings, even though the failure result from a bona fide mistake as to the law, cannot be sanctioned under the Act.

This conclusion is unaffected by the fact that some purchasers choose not to accept the full offer of an investment contract by declining to enter into a service contract with the respondents. The Securities Act prohibits the offer as well as the sale of unregistered, non-exempt securities. Hence it is enough that the respondents merely offer the essential ingredients of an investment contract.

We reject the suggestion of the Circuit Court of Appeals, . . . that an investment contract is necessarily missing where the enterprise is not speculative or promotional in character and where the tangible interest which is sold has intrinsic value independent of the success of the enterprise as a whole. The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others. If that test be satisfied, it is immaterial whether the enterprise is speculative or non-speculative or whether there is a sale of property with or without intrinsic value. The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae.

Reversed.

MR. JUSTICE JACKSON took no part in the consideration or decision of this case.

DISSENT: MR. JUSTICE FRANKFURTER, dissenting.

"Investment contract" is not a term of art; it is a conception dependent upon the circumstances of a particular situation. If this case came before us on a finding authorized by Congress that the facts disclosed an "investment contract" within the general scope of § 2 (1) of the Securities Act, the Securities and Exchange Commission's finding would govern, unless, on the record, it was wholly unsupported. But that is not the case before us. Here the ascertainment of the existence of an "investment contract" had to be made independently by the District Court and it found against its existence. . . . The Circuit Court of Appeals for the Fifth Circuit sustained that finding. . . . If respect is to be paid to the wise rule of judicial administration under which this Court does not upset concurrent findings of two lower courts in the ascertainment of facts and the relevant inferences to be drawn from them, this case clearly calls for its application. . . . . For the crucial issue in this case turns on whether the contracts for the land and the contracts for the management of the property were in reality separate agreements or merely parts of a single transaction. It is clear from its opinion that the District Court was warranted in its conclusion that the record does not establish the existence of an investment contract:

". . . the record in this case shows that not a single sale of citrus grove property was made by the Howey Company during the period involved in this suit, except to purchasers who actually inspected the property before purchasing the same. The record further discloses that no purchaser is required to engage the Service Company to care for his property and that of the fifty-one purchasers acquiring property during this period, only forty-two entered into contracts with the Service Company for the care of the property." 60 F.Supp. at 442.

Simply because other arrangements may have the appearances of this transaction but are employed as an evasion of the Securities Act does not mean that the present contracts were evasive. I find nothing in the Securities Act to indicate that Congress meant to bring every innocent transaction within the scope of the Act simply because a perversion of them is covered by the Act.

Gerald M. Hocking**,** Plaintiff-Appellant, v. Maylee Dubois and Vitousek & Dick Realtors, Inc., a Hawaii corporation, Defendants-Appellees

United States Court of Appeals for the Ninth Circuit

839 F.2d 560

February 10, 1988, Filed

JUDGES: Alfred T. Goodwin, Procter Hug, Jr. and Stephen Reinhardt, Circuit Judges. Hug, Circuit Judge, dissenting.

OPINION: REINHARDT, Circuit Judge:

This is an action for fraud brought under the federal securities laws against a real estate agent and the broker that employed her. Appellant based federal jurisdiction on the claim that the real estate agent offered a "security" within the meaning of the federal securities laws. He also alleged pendent state causes of action for fraud. . . . We hold that . . . the offer of a condominium with an option to participate in a rental pool arrangement constitutes the offer of an investment contract under the securities laws. Accordingly, we reverse the grant of summary judgment. . . .

I.

Gerald Hocking visited Hawaii and became interested in buying a condominium there as an investment. When he returned to his home in Las Vegas, he made this known to a co-worker whose wife, Maylee Dubois, was a licensed real estate agent in Hawaii. She was employed by Vitousek & Dick Realtors, Inc., a Hawaiian real estate brokerage firm. A meeting was arranged between Hocking and Dubois. Subsequently, Dubois agreed to help Hocking find a suitable unit.

Dubois found a condominium unit owned by Tovik and Yaacov Liberman that was for sale. The unit was located in a resort complex developed by Aetna Life Insurance Company ("Aetna"). As a part of the original development, Aetna had offered purchasers an opportunity to participate in a rental pool arrangement ("RPA"). n2 This was optional and the Libermans had not participated in the rental pool.

- - - - - - - - - - - - - - Footnote - - - - - - - - - - - - - - -
n2 Under an RPA, an agent is responsible for renting and managing the resort project. The rental income from the units is pooled, and after each owner is assessed a pro rata share of the agent's costs, each owner receives a pro rata share of the rental income whether or not the owner's individual unit actually was rented.
- - - - - - - - - - - - End Footnote- - - - - - - - - - - - - -

In arranging the sale of the Libermans' condominium, Dubois advised him of the availability of the rental pool arrangement. . . . Hocking purchased the condominium unit from the Libermans on June 23, 1979. On July 5, 1979, Hocking entered into a rental management agreement with Hotel Corporation of the Pacific ("HCP") and a rental pool agreement that was to take effect six months later. Although the record is not clear on the relationship between HCP and the developer, Aetna, it appears that HCP performed management services at the option of the condominium purchasers.

Hocking subsequently filed suit alleging violations of the antifraud provisions of the Securities Exchange Act of 1934 . . and Rule 10b-5 promulgated thereunder, ... and state law claims of fraud, negligence, and breach of fiduciary duty. He alleged various acts of fraud by Dubois in inducing him to buy the unit and in services she performed or failed to perform thereafter. The district court granted summary judgment for defendants on the securities claim and dismissed the pendent state claims for lack of subject matter jurisdiction.

II.

We review the grant of summary judgment *de novo*. . . . We also review *de novo* the district court's determination whether a transaction is a security.

III.

The term "security" is defined in section 2 of the Securities Act of 1933, and in section 3 of the Securities Exchange Act of 1934. The sections, which are substantially identical, . . . define a security to include any "investment contract." However, the definition is not a static one. Congress cast it "in sufficiently broad and general terms so as to include

within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security." It embodies a flexible principle "capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

The now classic definition of an investment contract is found in *SEC v. W. J. Howey Co.* In *Howey*, investors purchased portions of a citrus grove in Florida. The seller offered each investor a land sales contract and a service contract under which defendant cultivated, harvested, and marketed the fruit. The service contract was for a ten-year period with no option to cancel. The investors nominally owned the land, but had no right to specific fruit or to enter the land. Their rights were limited to the receipt of profits from the pooling of all the harvested fruit. . . . The Court noted that the buyers lacked the knowledge, skill, and equipment necessary in the citrus fruit business and that the only way they could hope for a return on their investment was by absolute reliance on the efforts and abilities of the Howey Company. The Court, in finding an investment contract, held:

> An investment contract for purposes of the Securities Act means 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 the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise. Under *Howey*, then, an investment contract consists of (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profits produced by the efforts of others.

Generally, simple transactions in real estate, without more, do not satisfy the *Howey* criteria. . . . When a purchaser is motivated exclusively by a desire to occupy or develop the land personally, no security is involved.

Real estate transactions may involve an offer of securities when an investor is offered both an interest in real estate *and* a collateral expectation of profits. . . . However, drawing the line between the offering of land sales contracts and investment contracts has not been easy. To resolve this difficulty, at least in the area of condominiums, the Securities and Exchange Commission issued guidelines in 1973 on the applicability of federal securities laws to the burgeoning resort condominium market. . . . . We read the *Howey* criteria in light of those guidelines.

In Release 5347, the Commission states unequivocally that it will view a condominium as a security if it is offered with any one of three specified rental arrangements. The second of these arrangements, the controlling one here, is "the offering of participation in a rental pool arrangement." 38 Fed. Reg. 1735, 1736 (1973). Unlike a transaction covered under the first arrangement, the offering of a condominium with an RPA *automatically* makes the investment a security. . . . Release 5347 is controlling here, and compels the conclusion that the offer of the condominium with an RPA option constituted the offer of a security.

IV.

Even apart from the guidelines, we find that under the three *Howey* criteria an offer of a condominium with an RPA constitutes an offer of an investment contract.

1. *Investment of Money*. Defendants do not dispute that the condominium purchase satisfied *Howey's* first requirement. Hocking invested money in the condominium.

2. *Common Enterprise*. There has been some disagreement among the circuit courts of appeals on what satisfies the requirement of a common enterprise. . . .

It is readily apparent that an RPA for condominiums is a common enterprise. Each investor buys one share -- a condominium -- in a common venture that pools the rents from all of the units. The success of each participant's individual investment clearly depends on the entire RPA's success. At least with respect to the common enterprise prong of *Howey*, this is precisely the reason why the SEC felt that an offer of a condominium with an option for RPA *automatically* constitutes the offer of a security.

3. *Expectation of Profits Produced by Others' Efforts*. With respect to the third prong of *Howey*, i.e., the expectation of profits produced by the efforts of others, we conclude that this requisite is met *whenever* a condominium is sold with an RPA option. This is what the Commission has done in its guidelines for condominiums. The rationale of the SEC's *automatic* application of the securities laws to RPAs is not expressly set forth in the Release. . . .

The SEC and its advisory committee recognized the wisdom of having a rule that would make the sale of all the condominiums in a particular condominium development subject to the securities laws or would exclude the sale of all

those units -- regardless of the fortuity of the individual economic expectations of the particular buyer. . . . We agree, and believe that the Release's bright line rule reflects the only proper interpretation of *Howey* as applied to condominiums. The purchase of a condominium with an RPA option thus meets the third *Howey* requisite that there be an expectation of profits based upon the entrepreneurial or managerial efforts of others. n8 Not only, then, does the alleged transaction at issue constitute the offer of a security under the SEC guidelines, but it also constitutes a security under the test set forth in *Howey*.

- - - - - - - - - - - - - - Footnote - - - - - - - - - - - - - - -

n8 The third *Howey* criterion originally was that profits from the investment ought to accrue "solely from the efforts of others." However, neither the Court nor this circuit has applied this criterion rigidly. For example, we have found securities to exist when profits are made in part by the efforts of others, and in part through the efforts of the purchaser. . . . Just as the *Howey* test allows us to find the existence of a security when profits are expected from the purchaser's own efforts as well as from the efforts of others, it also allows us to find a security when profits are expected from appreciation of condominium value at time of resale as well as from the efforts of others. This latter situation characterizes the facts here, where profits from the investment in a condominium with an RPA may come from 1) the condominium's pro rata share of net rents from the RPA, which depends upon the efforts of others, and 2) the appreciation on the condominium at the time of resale, which does not depend upon others' efforts. The existence of these two avenues for profit also characterized the facts of *Howey*, where profits came from harvested fruit, but also from the increased value of the land over time. What was important there, as is important here, is that the profits during the period of ownership come from the entrepreneurial or managerial efforts of others, and that the efforts of those other than the investor are the "undeniably significant ones". *Howey*, therefore, does not contemplate that profits must come only from the efforts of others, and not also from increased land values. Our reasoning is consistent with that of the SEC, for the guidelines contemplate that the offer of a condominium with an RPA option necessarily constitutes the offer of a security, irrespective of an expectation of profits from appreciation at the time of resale.
- - - - - - - - - - - - End Footnote- - - - - - - - - - - - - -

V. [omitted]

VI.

. . . . Because the condominium with its RPA is a security, Dubois acted as Hocking's securities broker. Just like any other purchaser of securities, Hocking may sue his own broker for fraudulent representations made in connection with the offer or sale of a security. . . . It is relatively common for securities purchasers to sue their own brokers; often, the sellers of the securities are not even known, let alone the sellers' brokers. A security broker's liability is not dependent on whether the seller is a defendant in the action or whether the broker acted as the seller's agent. Of course, Dubois' liability will depend on whether Hocking can show a fraudulent representation or other violation of a duty owed by Dubois to Hocking. That issue is not before us now.

Accordingly, the judgment below is reversed and the case is remanded for further proceedings consistent with this opinion.

REVERSED AND REMANDED.

DISSENT: HUG, Circuit Judge, dissenting:

I respectfully dissent.

. . . In summary, I submit that, regardless of the validity of the SEC's bright line rule for the purpose of requiring developers to register their projects, it makes no sense to apply that rule to this case. Here we have the Libermans, who bought a unit, rejected the rental pool, and now seek to sell the unit. Dubois notified Hocking that if he bought the unit he could perhaps participate in the developer's rental pool. It is hard to envision either the Libermans or Dubois as promoters offering the kind of package that constitutes an "investment contract," as defined by the Supreme Court.

I would affirm the dismissal for lack of subject matter jurisdiction because no security was involved.

Escott v. BarChris Construction Corp.

United States District Court for the Southern District of New York

283 F. Supp. 643 (1968)

This is an action by purchasers of 5 1/2 per cent convertible subordinated fifteen year debentures of BarChris Construction Corporation (BarChris). Plaintiffs purport to sue on their own behalf and "on behalf of all other and present and former holders" of the debentures. . . . The action is brought under Section 11 of the Securities Act of 1933 (15 U.S.C. § 77k). Plaintiffs allege that the registration statement with respect to these debentures filed with the Securities and Exchange Commission, which became effective on May 16, 1961, contained material false statements and material omissions.

Defendants fall into three categories: (1) the persons who signed the registration statement; (2) the underwriters, consisting of eight investment banking firms, led by Drexel & Co. (Drexel); and (3) BarChris's auditors, Peat, Marwick, Mitchell & Co. (Peat, Marwick).

. . . On the main issue of liability, the questions to be decided are (1) did the registration statement contain false statements of fact, or did it omit to state facts which should have been stated in order to prevent it from being misleading; (2) if so, were the facts which were falsely stated or omitted "material" within the meaning of the Act; (3) if so, have defendants established their affirmative defenses?

Before discussing these questions, some background facts should be mentioned. At the time relevant here, BarChris was engaged primarily in the construction of bowling alleys, somewhat euphemistically referred to as "bowling centers." . . .

BarChris's sales increased dramatically from 1956 to 1960. According to the prospectus, net sales, in round figures, in 1956 were some $800,000, in 1957 $1,300,000, in 1958 $1,700,000. In 1959 they increased to over $3,300,000, and by 1960 they had leaped to over $9,165,000. . . . BarChris was compelled to expend considerable sums in defraying the cost of construction before it received reimbursement. As a consequence, BarChris was in constant need of cash to finance its operations, a need which grew more pressing as operations expanded.

In December 1959, BarChris sold 560,000 shares of common stock to the public at $3.00 per share. This issue was underwritten by Peter Morgan & Company, one of the present defendants. By early 1961, BarChris needed additional working capital. The proceeds of the sale of the debentures involved in this action were to be devoted, in part at least, to fill that need.

The registration statement of the debentures, in preliminary form, was filed with the Securities and Exchange Commission on March 30, 1961. A first amendment was filed on May 11 and a second on May 16. The registration statement became effective on May 16. The closing of the financing took place on May 24. On that day BarChris received the net proceeds of the financing.

By that time BarChris was experiencing difficulties in collecting amounts due from some of its customers. Some of them were in arrears in payments due to factors on their discounted notes. As time went on those difficulties increased. Although BarChris continued to build alleys in 1961 and 1962, it became increasingly apparent that the industry was overbuilt. Operators of alleys, often inadequately financed, began to fail. Precisely when the tide turned is a matter of dispute, but at any rate, it was painfully apparent in 1962.

In May of that year BarChris made an abortive attempt to raise more money by the sale of common stock. It filed with the Securities and Exchange Commission a registration statement for the stock issue which it later withdrew. In October 1962 BarChris came to the end of the road. On October 29, 1962, it filed in this court a petition for an arrangement under Chapter XI of the Bankruptcy Act. BarChris defaulted in the payment of the interest due on November 1, 1962 on the debentures.

The Debenture Registration Statement

. . . . In connection with the sale of common stock, BarChris had issued purchase warrants. In January 1961 a second registration statement was filed in order to update the information pertaining to these warrants. Grant had prepared that statement as well. Some of the basic information needed for the debenture registration statement was contained in the registration statements previously filed with respect to the common stock and warrants. . . .

Peat, Marwick, BarChris's auditors, who had previously audited BarChris's annual balance sheet and earnings figures for 1958 and 1959, did the same for 1960. These figures were set forth in the registration statement. Peat, Marwick undertook a so-called "S-1 review," the proper scope of which is one of the matters debated here. The registration statement in its final form contained a prospectus as well as other information. Plaintiffs' claims of falsities and omissions pertain solely to the prospectus, not to the additional data.

The prospectus contained, among other things, a description of BarChris's business, a description of its real property, some material pertaining to certain of its subsidiaries, and remarks about various other aspects of its affairs. It also contained financial information. It included a consolidated balance sheet as of December 31, 1960, with elaborate explanatory notes. These figures had been audited by Peat, Marwick. It also contained unaudited figures as to net sales, gross profit and net earnings for the first quarter ended March 31, 1961, as compared with the similar quarter for 1960. In addition, it set forth figures as to the company's backlog of unfilled orders as of March 31, 1961, as compared with March 31, 1960, and figures as to BarChris's contingent liability, as of April 30, 1961, on customers' notes discounted and its contingent liability under the so-called alternative method of financing.

Plaintiffs challenge the accuracy of a number of these figures. They also charge that the text of the prospectus, apart from the figures, was false in a number of respects, and that material information was omitted. Each of these contentions, after eliminating duplications, will be separately considered. . . .

Summary

For convenience, the various falsities and omissions which I have discussed in the preceding pages are recapitulated here. They were as follows:

1. 1960 Earnings

(a) Sales	
As per prospectus	$9,165,320
Correct figure	8,511,420
Overstatement	$ 653,900

(b) Net Operating Income	
As per prospectus	$1,742,801
Correct figure	1,496,196
Overstatement	$ 246,605

(c) Earnings per Share	
As per prospectus	$ .75
Correct figure	.65
Overstatement	$ .10

2. 1960 Balance Sheet

Current Assets	
As per prospectus	$4,524,021
Correct figure	3,914,332
Overstatement	$ 609,689

3. Contingent Liabilities as of December 31, 1960 on Alternative Method of Financing

As per prospectus	$ 750,000
Correct figure	1,125,795
Understatement	$ 375,795
Capitol Lanes should have been shown as a direct liability	$ 325,000

4. Contingent Liabilities as of April 30, 1961

As per prospectus	$ 825,000
Correct figure	1,443,853
Understatement	$ 618,853
Capitol Lanes should have been shown as a direct liability	$ 314,166

5. Earnings Figures for Quarter ending March 31, 1961

(a) Sales

As per prospectus	$2,138,455
Correct figure	1,618,645
Overstatement	$ 519,810

(b) Gross Profit

As per prospectus	$ 483,121
Correct figure	252,366
Overstatement	$ 230,755

6. Backlog as of March 31, 1961

As per prospectus	$6,905,000
Correct figure	2,415,000
Overstatement	$4,490,000

7. Failure to Disclose Officers' Loans Outstanding and Unpaid on May 16, 1961 — $ 386,615

8. Failure to Disclose Use of Proceeds in Manner not Revealed in Prospectus — Approximately $1,160,000

9. Failure to Disclose Customers' Delinquencies in May 1961 and BarChris's Potential Liability with Respect Thereto — Over $1,350,000

10. Failure to Disclose the Fact that BarChris was Already Engaged, and was about to be More Heavily Engaged, in the Operation of Bowling Alleys

Materiality

It is a prerequisite to liability under Section 11 of the Act that the fact which is falsely stated in a registration statement, or the fact that is omitted when it should have been stated to avoid misleading, be "material." . . .

Judged by this test, there is no doubt that many of the misstatements and omissions in this prospectus were material.

The "Due Diligence" Defenses

Section 11(b) of the Act provides that:

> " . . . no person, other than the issuer, shall be liable . . . who shall sustain the burden of proof . . .
>
> (3) that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert . . . he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading; . . . and (C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) . . . he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . . ."

Section 11(c) defines "reasonable investigation" as follows:

> "In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property."

Every defendant, except BarChris itself, to whom, as the issuer, these defenses are not available, and except Peat, Marwick, whose position rests on a different statutory provision, has pleaded these affirmative defenses. Each claims that (1) as to the part of the registration statement purporting to be made on the authority of an expert (which, for convenience, I shall refer to as the "expertised portion"), he had no reasonable ground to believe and did not believe that there were any untrue statements or material omissions, and (2) as to the other parts of the registration statement, he made a reasonable investigation, as a result of which he had reasonable ground to believe and did believe that the registration statement was true and that no material fact was omitted. As to each defendant, the question is whether he has sustained the burden of proving these defenses. Surprising enough, there is little or no judicial authority on this question. No decisions directly in point under Section 11 have been found.. . .

The only expert, in the statutory sense, was Peat, Marwick, and the only parts of the registration statement which purported to be made upon the authority of an expert were the portions which purported to be made on Peat, Marwick's authority. . . .

I turn now to the question of whether defendants have proved their due diligence defenses. The position of each defendant will be separately considered.

Russo

Russo was, to all intents and purposes, the chief executive officer of BarChris. He was a member of the executive committee. He was familiar with all aspects of the business. He was personally in charge of dealings with the factors. He acted on BarChris's behalf in making the financing agreements with Talcott and he handled the negotiations with Talcott in the spring of 1961. He talked with customers about their delinquencies.

Russo prepared the list of jobs which went into the backlog figure. He knew the status of those jobs. In addition to being chief executive officer of BarChris, he was a director of T-Bowl International, Inc., and the principals in St. Ann's were his friends.

It was Russo who arranged for the temporary increase in BarChris's cash in banks on December 31, 1960, a transaction which borders on the fraudulent. He was thoroughly aware of BarChris's stringent financial condition in May 1961. He had personally advanced large sums to BarChris of which $175,000 remained unpaid as of May 16.

In short, Russo knew all the relevant facts. He could not have believed that there were no untrue statements or material omissions in the prospectus. Russo has no due diligence defenses.

Vitolo and Pugliese

They were the founders of the business who stuck with it to the end. Vitolo was president and Pugliese was vice president. Despite their titles, their field of responsibility in the administration of BarChris's affairs during the period in question seems to have been less all-embracing than Russo's. Pugliese in particular appears to have limited his activities to supervising the actual construction work.

Vitolo and Pugliese are each men of limited education. It is not hard to believe that for them the prospectus was difficult reading, if indeed they read it at all. But whether it was or not is irrelevant. The liability of a director who signs a registration statement does not depend upon whether or not he read it or, if he did, whether or not he understood what he was reading.

And in any case, Vitolo and Pugliese were not as naive as they claim to be. They were members of BarChris's executive committee. At meetings of that committee BarChris's affairs were discussed at length. They must have known what was going on. Certainly they knew of the inadequacy of cash in 1961. They knew of their own large advances to the company which remained unpaid. They knew that they had agreed not to deposit their checks until the financing proceeds were received. They knew and intended that part of the proceeds were to be used to pay their own loans.

All in all, the position of Vitolo and Pugliese is not significantly different, for present purposes, from Russo's. They could not have believed that the registration statement was wholly true and that no material facts had been omitted. And in any case, there is nothing to show that they made any investigation of anything which they may not have known about or understood. They have not proved their due diligence defenses.

Kircher

Kircher was treasurer of BarChris and its chief financial officer. He is a certified public accountant and an intelligent man. He was thoroughly familiar with BarChris's financial affairs. He knew the terms of BarChris's agreements with Talcott. He knew of the customers' delinquency problem. He participated actively with Russo in May 1961 in the successful effort to hold Talcott off until the financing proceeds came in. He knew how the financing proceeds were to be applied and he saw to it that they were so applied. He arranged the officers' loans and he knew all the facts concerning them. . . .

Kircher's contention is that he had never before dealt with a registration statement, that he did not know what it should contain, and that he relied wholly on Grant, Ballard and Peat, Marwick to guide him. He claims that it was their fault, not his, if there was anything wrong with it. He says that all the facts were recorded in BarChris's books where these "experts" could have seen them if they had looked. He says that he truthfully answered all their questions. In effect, he

says that if they did not know enough to ask the right questions and to give him the proper instructions, that is not his responsibility.

There is an issue of credibility here. In fact, Kircher was not frank in dealing with Grant and Ballard. He withheld information from them. But even if he had told them all the facts, this would not have constituted the due diligence contemplated by the statute. Knowing the facts, Kircher had reason to believe that the expertised portion of the prospectus, i.e., the 1960 figures, was in part incorrect. He could not shut his eyes to the facts and rely on Peat, Marwick for that portion.

As to the rest of the prospectus, knowing the facts, he did not have a reasonable ground to believe it to be true. On the contrary, he must have known that in part it was untrue. Under these circumstances, he was not entitled to sit back and place the blame on the lawyers for not advising him about it.

Kircher has not proved his due diligence defenses.

Trilling

Trilling's position is somewhat different from Kircher's. He was BarChris's controller. He signed the registration statement in that capacity, although he was not a director.

Trilling entered BarChris's employ in October 1960. He was Kircher's subordinate. When Kircher asked him for information, he furnished it. On at least one occasion he got it wrong. . . . Trilling may well have been unaware of several of the inaccuracies in the prospectus. But he must have known of some of them. . . . In the light of these facts, I cannot find that Trilling believed the entire prospectus to be true.

But even if he did, he still did not establish his due diligence defenses. He did not prove that as to the parts of the prospectus expertised by Peat, Marwick he had no reasonable ground to believe that it was untrue. He also failed to prove, as to the parts of the prospectus not expertised by Peat, Marwick, that he made a reasonable investigation which afforded him a reasonable ground to believe that it was true. As far as appears, he made no investigation. He did what was asked of him and assumed that others would properly take care of supplying accurate data as to the other aspects of the company's business. This would have been well enough but for the fact that he signed the registration statement. As a signer, he could not avoid responsibility by leaving it up to others to make it accurate. Trilling did not sustain the burden of proving his due diligence defenses.

Birnbaum

Birnbaum was a young lawyer, admitted to the bar in 1957, who, after brief periods of employment by two different law firms and an equally brief period of practicing in his own firm, was employed by BarChris as house counsel and assistant secretary in October 1960. Unfortunately for him, he became secretary and a director of BarChris on April 17, 1961, after the first version of the registration statement had been filed with the Securities and Exchange Commission. He signed the later amendments, thereby becoming responsible for the accuracy of the prospectus in its final form.

Although the prospectus, in its description of "management," lists Birnbaum among the "executive officers" and devotes several sentences to a recital of his career, the fact seems to be that he was not an executive officer in any real sense. He did not participate in the management of the company. As house counsel, he attended to legal matters of a routine nature. . . .

Birnbaum examined contracts. In that connection he advised BarChris that the T-Bowl contracts were not legally enforceable. He was thus aware of that fact.

One of Birnbaum's more important duties, first as assistant secretary and later as full-fledged secretary, was to keep the corporate minutes of BarChris and its subsidiaries. This necessarily informed him to a considerable extent about the company's affairs. Birnbaum was not initially a member of the executive committee, however, and did not keep its minutes at the outset. According to the minutes, the first meeting which he attended, "upon invitation of the

Committee," was on March 22, 1961. He became a member shortly thereafter and kept the minutes beginning with the meeting of April 24, 1961.

It seems probable that Birnbaum did not know of many of the inaccuracies in the prospectus. He must, however, have appreciated some of them. In any case, he made no investigation and relied on the others to get it right. Unlike Trilling, he was entitled to rely upon Peat, Marwick for the 1960 figures, for as far as appears, he had no personal knowledge of the company's books of account or financial transactions. But he was not entitled to rely upon Kircher, Grant and Ballard for the other portions of the prospectus. As a lawyer, he should have known his obligations under the statute. He should have known that he was required to make a reasonable investigation of the truth of all the statements in the unexpertised portion of the document which he signed. Having failed to make such an investigation, he did not have reasonable ground to believe that all these statements were true. Birnbaum has not established his due diligence defenses except as to the audited 1960 figures. . . .

The Underwriters and Coleman

The underwriters other than Drexel made no investigation of the accuracy of the prospectus. . . . Drexel did make an investigation. The work was in charge of Coleman, a partner of the firm, assisted by Casperson, an associate. Drexel's attorneys acted as attorneys for the entire group of underwriters. Ballard did the work, assisted by Stanton.

. . . . Coleman and Ballard asked pertinent questions and received answers which satisfied them. . . . Ballard, without checking, relied on the information which he got from Kircher. He also relied on Grant who, as company counsel, presumably was familiar with its affairs.

The formal opinion which Ballard's firm rendered to the underwriters at the closing on May 24, 1961 made clear that this is what he had done. The opinion stated:

> "In the course of the preparation of the Registration Statement and Prospectus by the Company, we have had numerous conferences with representatives of and counsel for the Company and with its auditors and we have raised many questions regarding the business of the Company. Satisfactory answers to such questions were in each case given us, and all other information and documents we requested have been supplied. We are of the opinion that the *data presented* to us are accurately reflected in the Registration Statement and Prospectus and that there has been omitted from the Registration Statement no material facts *included in such data*. Although *we have not otherwise verified* the completeness or accuracy of the information furnished to us, on the basis of the foregoing and with the exception of the financial statements and schedules (which this opinion does not pass upon), we have no reason to believe that the Registration Statement or Prospectus contains any untrue statement of any material fact or omits to state a material fact required to be stated therein or necessary in order to make the statements therein not misleading."

It is clear that no effectual attempt at verification was made. . . . Are underwriters in a different position, as far as due diligence is concerned?

The underwriters say that the prospectus is the company's prospectus, not theirs. Doubtless this is the way they customarily regard it. But the Securities Act makes no such distinction. The underwriters are just as responsible as the company if the prospectus is false. And prospective investors rely upon the reputation of the underwriters in deciding whether to purchase the securities. . . .

The purpose of Section 11 is to protect investors. To that end the underwriters are made responsible for the truth of the prospectus. If they may escape that responsibility by taking at face value representations made to them by the company's management, then the inclusion of underwriters among those liable under Section 11 affords the investors no additional protection. To effectuate the statute's purpose, the phrase "reasonable investigation" must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of "data presented" to them by the company. It should make no difference that this data is elicited by questions addressed to the company officers by the underwriters, or that the underwriters at the time believe that the company's officers are truthful and

reliable. In order to make the underwriters' participation in this enterprise of any value to the investors, the underwriters must make some reasonable attempt to verify the data submitted to them. They may not rely solely on the company's officers or on the company's counsel. A prudent man in the management of his own property would not rely on them.

It is impossible to lay down a rigid rule suitable for every case defining the extent to which such verification must go. It is a question of degree, a matter of judgment in each case. In the present case, the underwriters' counsel made almost no attempt to verify management's representations. I hold that that was insufficient. . . .

The other underwriters, who did nothing and relied solely on Drexel and on the lawyers, are also bound by it. It follows that although Drexel and the other underwriters believed that those portions of the prospectus were true, they had no reasonable ground for that belief, within the meaning of the statute. Hence, they have not established their due diligence defense . . . .

Peat, Marwick

Section 11(b) provides: "Notwithstanding the provisions of subsection (a) no person . . . shall be liable as provided therein who shall sustain the burden of proof —

> "(3) that . . . (B) as regards any part of the registration statement purporting to be made upon his authority as an expert . . . (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . . ."

This defines the due diligence defense for an expert. Peat, Marwick has pleaded it.

The part of the registration statement purporting to be made upon the authority of Peat, Marwick as an expert was, as we have seen, the 1960 figures. But because the statute requires the court to determine Peat, Marwick's belief, and the grounds thereof, "at the time such part of the registration statement became effective," for the purposes of this affirmative defense, the matter must be viewed as of May 16, 1961, and the question is whether at that time Peat, Marwick, after reasonable investigation, had reasonable ground to believe and did believe that the 1960 figures were true and that no material fact had been omitted from the registration statement which should have been included in order to make the 1960 figures not misleading. In deciding this issue, the court must consider not only what Peat, Marwick did in its 1960 audit, but also what it did in its subsequent "S-1 review." The proper scope of that review must also be determined. . . .

The 1960 Audit

Peat, Marwick's work was in general charge of a member of the firm, Cummings, and more immediately in charge of Peat, Marwick's manager, Logan. Most of the actual work was performed by a senior accountant, Berardi, who had junior assistants, one of whom was Kennedy. Berardi was then about thirty years old. He was not yet a C.P.A. He had had no previous experience with the bowling industry. This was his first job as a senior accountant. He could hardly have been given a more difficult assignment. . . .

In substance, what Berardi did is similar to what Grant and Ballard did. He asked questions, he got answers which he considered satisfactory, and he did nothing to verify them. . . .

Accountants should not be held to a standard higher than that recognized in their profession. I do not do so here. Berardi's review did not come up to that standard. He did not take some of the steps which Peat, Marwick's written program prescribed. He did not spend an adequate amount of time on a task of this magnitude. Most important of all, he was too easily satisfied with glib answers to his inquiries.

This is not to say that he should have made a complete audit. But there were enough danger signals in the materials which he did examine to require some further investigation on his part. Generally accepted accounting standards required such further investigation under these circumstances. It is not always sufficient merely to ask questions.

Here again, the burden of proof is on Peat, Marwick. I find that that burden has not been satisfied. I conclude that Peat, Marwick has not established its due diligence defense. . . .

UNITED STATES OF AMERICA, Plaintiff-Appellee, v. ATUL BHAGAT, Defendant-Appellant.

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

436 F.3d 1140

February 8, 2006, Filed

JUDGES: Mary M. Schroeder, Chief Judge, A. Wallace Tashima, and Johnnie B. Circuit Judges. Opinion by Judge Rawlinson; Dissent by Judge Tashima.

OPINION BY: Rawlinson, Circuit Judge

Appellant Atul Bhagat (Bhagat) challenges his convictions for insider trading; for securities tipping; and for obstructing the course of an SEC investigation.

Because any new factual theory referenced by the government during closing arguments was introduced for the proper purpose of impeaching Bhagat's credibility, and did not effect a constructive amendment or material variance of the indictment; the instructions conveyed all of the elements needed to obtain a conviction on the obstruction charge; and sufficient evidence supports Bhagat's conviction, we affirm the judgment of conviction.

I. FACTUAL and PROCEDURAL BACKGROUND

Bhagat's employer, Nvidia Corporation (Nvidia), successfully competed for a multi-million dollar contract to develop a video game console (the X-Box) for the Microsoft Corporation. Upon receiving the contract, Nvidia's Chief Executive Officer (CEO) sent a company-wide e-mail late Sunday night announcing the contract award. The next morning, Nvidia sent a number of follow-up e-mails. The first e-mail advised Nvidia employees that the X-Box information should be kept confidential. The other e-mails imposed a trading blackout on the purchase of Nvidia stock for several days, and required Nvidia's employees to cancel any open or outstanding orders for Nvidia stock.

A. Insider Trading Allegations Against Bhagat

The government's theory of prosecution was that Bhagat read the CEO's Sunday night e-mail prior to purchasing Nvidia stock. To support this theory, the government introduced evidence that Bhagat arrived at work on Monday mid-morning, and that all of the company-wide e-mails were on his computer. The government also introduced evidence that roughly twenty minutes after the final company-wide e-mail was sent, Bhagat purchased a large quantity of Nvidia stock -- his largest purchase in nearly three years. There was no direct evidence that Bhagat read any of the e-mail prior to executing his purchase. Instead, the government asked the jury to infer Bhagat's knowledge by virtue of the fact that he had probably read the original e-mail upon entering the office as a "normal, reasonable person" would.

Evidence was also presented that rumors about Nvidia and the X-Box contract began leaking in the industry the day after Bhagat purchased his stock, and the price of the stock rose sharply. Three days later, the news was made public and the price of Nvidia stock skyrocketed. Another four days later, Bhagat sold his stock, reaping a substantial profit.

Bhagat offered a different interpretation of the facts. He testified to conducting personal business for several hours upon reaching the office, and reading the company-wide e-mails at 1:00 p.m. -- roughly forty minutes after he purchased the stock. Upon learning of the trading blackout, Bhagat attempted to cancel his trade by contacting his broker, who advised him that it was too late. However, Bhagat could not remember which branch of the trading company he contacted, nor the name, or even the gender, of the representative to whom he spoke. Bhagat made no further attempt to divest himself of the stock. He concluded that to do so would further violate the trading blackout, although he sought no guidance from any Nvidia executive regarding his failure to cancel his pending trade.

To rebut the government's contention that his purchase of Nvidia stock was motivated by insider information, Bhagat testified that he purchased the stock after considering the general strength of the stock, and with the expectation that the company would win the X-Box contract. Bhagat introduced evidence that he was a consistent purchaser of technology-based stock. To counter the inference that he read the X-Box e-mail before executing his trades, Bhagat introduced evidence that, in a one-month period, he often did not send e-mails until after 1:00 p.m.

B. Tipping Allegations Against Bhagat

The prosecution sought to prove that Bhagat advised two friends to buy Nvidia stock before the X-Box information was officially released to the public. Less than one-half hour after Bhagat made his purchase, two of his friends, Puneet Mehrotra (Mehrotra) and Mamat Gill (Gill), purchased Nvidia stock. There was no direct evidence that Bhagat contacted Mehrotra or Gill prior to their purchases. However, Bhagat did send Gill an e-mail during the blackout period, the day after Gill purchased the Nvidia stock, containing a link to an internet article discussing Nvidia and the X-Box. Evidence was also introduced that Bhagat provided his real estate agent with the X-Box information before it was made public. Finally, Gill's purchase was his largest purchase of the year.

Bhagat denied telling anyone about the X-Box contract before it was made public. He countered the prosecution's evidence with the argument that a friend of Gill's, who worked for one of Nvidia's competitors, may have informed Gill of the X-Box contract award.

C. Reasons for the Increase in Nvidia's Stock Price

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D. Trial Proceedings

Bhagat was charged with insider trading, tipping, and obstructing an SEC investigation. The most hotly contested issue was whether the government adequately proved that Bhagat possessed prior knowledge of the X-Box contract award. The key provisions of the indictment are as follows:

> 5. On . . . March 5 . . . NVIDIA entered into a contract with Mircrosoft to develop . . . a . . . processor for . . . the "X-Box."
>
> 6. On Sunday, March 5 . . . NVIDIA's president . . . sent an e-mail message to all NVIDIA employees, including BHAGAT, announcing the contract. The e-mail . . . predicted that "if Xbox becomes as big as Sony Playstation, we generate about $ 2B in sales over 5 years."
>
> 7. On Monday, March 6 . . ., at 9:15 . . . NVIDIA's Vice President of Marketing sent an e-mail to all NVIDIA employees. The e-mail was entitled "xbox shhhhhh . . ." and said:
>
>> . . . keep the xbox news quiet . . . . Mircrosoft plans to make the news public this Friday **[**8]** . . . Lets don't jinx it!
>
> 8. On March 6 . . . at . . . 12:23 . . . BHAGAT placed a market order to purchase 1000 shares of NVIDIA stock.

The principal theory of the prosecution during the trial was that Bhagat knew about the contract from reading his own e-mail. During cross-examination, however, the prosecutor also questioned Bhagat about conversations among his co-workers that he had heard that morning concerning the X-Box contract. This line of questioning set the stage for what the parties refer to as the "office 'abuzz' theory."

Defense counsel informed the court that because the indictment did not include an allegation that Bhagat learned about the X-Box contract through office conversation, that theory should not be permitted as part of the government's case. In the alternative, defense counsel requested an instruction informing the jury that the mere existence of an open cubicle environment may not, standing alone, give rise to an inference that Bhagat possessed insider information. Ultimately, the court authorized the government to present the argument, and declined to give the requested instruction.

During closing arguments, the government referenced the "office abuzz" theory in passing, stating that the jury should consider the fact that the office was "abuzz" with the news of the X-Box contract, and that Bhagat had to walk through the office to reach his cubicle. The government also repeatedly informed the jury that in order to find Bhagat guilty, the government would have to prove that he read the company-wide e-mails prior to purchasing the stock.

The jury convicted Bhagat of insider trading, of tipping Gill, and of obstructing an SEC investigation by making false statements to SEC investigators.

E. Sentencing Proceedings

[deleted]

F. Post-trial Motions

Bhagat moved for acquittal on the basis of insufficient evidence. In the alternative, he sought a new trial on the same grounds he asserts in this appeal. The district court denied Bhagat's motions and Bhagat timely appealed.

II. DISCUSSION

A. Standards of Review

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B. Constructive Amendment or Material Variance

[deleted]

C. Jury Instruction for Obstructing an Agency Proceeding

Bhagat was convicted under 18 U.S.C. § 1505 for the crime of obstructing an SEC investigative proceeding by making false statements to SEC investigators. The government was required to prove three elements: (1) that there was an agency proceeding; (2) that the defendant was aware of that proceeding; and (3) that the defendant "intentionally endeavored corruptly to influence, obstruct or impede the pending proceeding." Because Bhagat failed to object to the instructions as given, we review for plain error. . . .

Because the provided jury instructions adequately addressed the elements needed to obtain a conviction under 18 U.S.C. § 1505, Bhagat is not entitled to a new trial on this basis.

D. Sufficiency of the Evidence

Evidence is sufficient to support a conviction if, considering the evidence in the light most favorable to the prosecution, any reasonable juror could have found the essential elements of the offense beyond a reasonable doubt. For the following reasons, we hold that sufficient evidence supported Bhagat's convictions on all grounds.

1. Insider Trading

To convict Bhagat of insider trading, the government was required to prove that he "traded stock on the basis of material, nonpublic information."

The government offered significant evidence to support the jury's conclusion that Bhagat was aware of the confidential X-Box information before he executed his trades. The X-Box e-mails were sent prior to his purchase. The e-mails were found on his computer. Bhagat was at his office for several hours prior to executing his trade, which provided him the opportunity to read the e-mails. Finally, Bhagat took virtually no action to divest himself of the stock, or to inform his company that he had violated the company's trading blackout. The fact that this evidence was all circumstantial does not lessen its sufficiency to support a guilty verdict.

2. Obstructing an Agency Proceeding

To convict Bhagat for obstructing an agency proceeding pursuant to 18 U.S.C. § 1505, the government was required to prove that an agency of the United States government was conducting a proceeding; that the defendant was aware of that proceeding; and that the defendant intentionally interfered with, or obstructed the course of, that proceeding.

Sufficient evidence also supports the jury's verdict on this charge. It is undisputed that there was an SEC investigative proceeding of which Bhagat was aware. The prosecution also introduced evidence that Bhagat intentionally obstructed that proceeding by providing the SEC investigators with false information to cover up his acts of insider trading and tipping and eliminate himself as a suspect. No relief is warranted on this ground.

3. Tipping

To convict Bhagat of tipping Gill, the government was required to prove that the tipper, Bhagat, provided the tippee, Gill, with material, inside information, prior to the tippee's purchase of stock.

Viewing the evidence in the light most favorable to the prosecution, we cannot say that no reasonable trier of fact could have found Bhagat guilty. Bhagat and Gill were friends; Bhagat had provided inside information to his real estate broker, with whom he shared a more distant relationship; Gill purchased stock shortly after Bhagat; and Gill's purchase was his largest purchase of the year.

E. Sentencing

[deleted]

III. CONCLUSION

The government's use of the "office abuzz" theory did not constructively amend the indictment or create a material variance between the facts alleged in the indictment and the evidence presented at trial.

The district court provided adequate jury instructions on the charge of obstructing an agency proceeding.

Sufficient evidence supported Bhagat's convictions on all counts.

CONVICTION AFFIRMED, SENTENCE REMANDED.

DISSENT BY: A. Wallace Tashima

SECURITIES AND EXCHANGE COMMISSION, Plaintiff-Appellant, v. TEXAS GULF SULPHUR CO., a Texas Corporation, et al., Defendants-Appellants

UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

401 F.2d 833

August 13, 1968, Decided

JUDGES: Lumbard, Chief Judge, and Waterman, Moore, Friendly, Smith, Kaufman, Hays, Anderson and Feinberg, Circuit Judges. Friendly, Circuit Judge (concurring). Irving R. Kaufman, Circuit Judge (concurring). Anderson, Circuit Judge (concurring). Hays, Circuit Judge (concurring in part and dissenting in part). Moore, Circuit Judge (dissenting) (with whom Chief Judge Lumbard concurs).

OPINION:

This action was commenced in the United States District Court for the Southern District of New York by the Securities and Exchange Commission (the SEC) against Texas Gulf Sulphur Company (TGS) and several of its officers, directors and employees, to enjoin certain conduct by TGS and the individual defendants said to violate Section 10(b) of the Act, 15 U.S.C. Section 78j(b), and Rule 10b-5 (the Rule), promulgated thereunder, and to compel the rescission by the individual defendants of securities transactions assertedly conducted contrary to law. . . .

THE FACTUAL SETTING

This action derives from the exploratory activities of TGS begun in 1957 on the Canadian Shield in eastern Canada. . . .

On October 29 and 30, 1963, Clayton conducted a ground geophysical survey which confirmed the presence of an anomaly and indicated the necessity of diamond core drilling for further evaluation. Drilling of the initial hole, K-55-1, at the strongest part of the anomaly was commenced on November 8. . . . The results were so remarkable that neither Clayton, an experienced geophysicist, nor four other TGS expert witnesses, had ever seen or heard of a comparable initial exploratory drill hole in a base metal deposit. . . . Drilling was resumed on March 31.

From November 12, 1963 to March 31, 1964, certain of the individual defendants, and persons said to have received "tips" from them, purchased TGS stock or calls thereon. Prior to these transactions these persons had owned 1135 shares of TGS stock and possessed no calls; thereafter they owned a total of 8235 shares and possessed 12,300 calls. . . .

Meanwhile, rumors that a major ore strike was in the making had been circulating throughout Canada. . . . The following morning, Sunday, with the aid of a public relations consultant, TGS drafted a press release designed to quell the rumors, which release was issued at 3:00 P.M. on Sunday, April 12, and which appeared in the morning newspapers of general circulation on Monday, April 13. It read in pertinent part as follows:

> NEW YORK, April 12 -- The following statement was made today by Dr. Charles F. Fogarty, executive vice president of Texas Gulf Sulphur Company, in regard to the company's drilling operations near Timmins, Ontario, Canada. Dr. Fogarty said:
>
> "During the past few days, the exploration activities of Texas Gulf Sulphur in the area of Timmins, Ontario, have been widely reported in the press, coupled with rumors of a substantial copper discovery there. These reports exaggerate the scale of operations, and mention plans and statistics of size and grade of ore that are without factual basis and have evidently originated by speculation of people not connected with TGS.
>
> "The facts are as follows. TGS has been exploring in the Timmins area for six years as part of its overall search in Canada and elsewhere for various minerals -- lead, copper, zinc, etc. During the course of this work, in Timmins as well as in Eastern Canada, TGS has conducted exploration entirely on its own, without the participation by others. Numerous prospects have been investigated by geophysical means and a large number of selected ones have been core-drilled. These cores are sent to the United States for assay and detailed examination as a matter of routine and on advice of expert Canadian legal counsel. No inferences as to grade can be drawn from this procedure.
>
> "Most of the areas drilled in Eastern Canada have revealed either barren pyrite or graphite without value; a few have resulted in discoveries of small or marginal sulphide ore bodies.
>
> "Recent drilling on one property near Timmins has led to preliminary indications that more drilling would be required for proper evaluation of this prospect. The drilling done to date has not been conclusive, but the statements made by many outside quarters are unreliable and include information and figures that are not available to TGS.

> "The work done to date has not been sufficient to reach definite conclusions and any statement as to size and grade of ore would be premature and possibly misleading. When we have progressed to the point where reasonable and logical conclusions can be made, TGS will issue a definite statement to its stockholders and to the public in order to clarify the Timmins project."

. . . . Meanwhile, drilling operations continued. . . . While drilling activity ensued to completion, TGC officials were taking steps toward ultimate disclosure of the discovery. . . . An official detailed statement, announcing a strike of at least 25 million tons of ore, based on the drilling data set forth above, was read to representatives of American financial media from 10:00 A.M. to 10:10 or 10:15 A.M. on April 16, and appeared over Merrill Lynch's private wire at 10:29 A.M. and, somewhat later than expected, over the Dow Jones ticker tape at 10:54 A.M.

Between the time the first press release was issued on April 12 and the dissemination of the TGS official announcement on the morning of April 16, the only defendants before us on appeal who engaged in market activity were Clayton and Crawford and TGS director Coates. Clayton ordered 200 shares of TGS stock through his Canadian broker on April 15 and the order was executed that day over the Midwest Stock Exchange. Crawford ordered 300 shares at midnight on the 15th and another 300 shares at 8:30 A.M. the next day, and these orders were executed over the Midwest Exchange in Chicago at its opening on April 16. Coates left the TGS press conference and called his broker son-in-law Haemisegger shortly before 10:20 A.M. on the 16th and ordered 2,000 shares of TGS for family trust accounts of which Coates was a trustee but not a beneficiary; Haemisegger executed this order over the New York and Midwest Exchanges, and he and his customers purchased 1500 additional shares.

During the period of drilling in Timmins, the market price of TGS stock fluctuated but steadily gained overall. On Friday, November 8, when the drilling began, the stock closed at 17 3/8. . . The price rose to 20 7/8 by December 13, when the chemical assay results of K-55-1 were received, and closed at a high of 24 1/8 on February 21, the day after the stock options had been issued. It had reached a price of 26 by March 31, after the land acquisition program had been completed and drilling had been resumed, and continued to ascend to 30 1/8 by the close of trading on April 10, at which time the drilling progress up to then was evaluated for the April 12th press release. On April 13, the day on which the April 12 release was disseminated, TGS opened at 30 1/8, rose immediately to a high of 32 and gradually tapered off to close at 30 7/8. It closed at 30 1/4 the next day, and at 29 3/8 on April 15. On April 16, the day of the official announcement of the Timmins discovery, the price climbed to a high of 37 and closed at 36 3/8. By May 15, TGS stock was selling at 58 1/4.

I. THE INDIVIDUAL DEFENDANTS

A. *Introductory*

Rule 10b-5, 17 CFR 240.10b-5, on which this action is predicated, provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> > (1) to employ any device, scheme, or artifice to defraud,
> >
> > (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> >
> > (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

Rule 10b-5 was promulgated pursuant to the grant of authority given the SEC by Congress in Section 10(b) of the Securities Exchange Act of 1934. By that Act Congress purposed to prevent inequitable and unfair practices and to insure fairness in securities transactions generally, whether conducted face-to-face, over the counter, or on exchanges. The Act and the Rule apply to the transactions here, all of which were consummated on exchanges. . . . The essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone" may not take "advantage of such information knowing it is unavailable to those with whom he is dealing," i.e., the investing public. *Matter of Cady, Roberts & Co*., 40 SEC 907, 912 (1961). Insiders, as directors or management officers are, of course, by this Rule, precluded from so unfairly dealing, but the Rule is also applicable to one possessing the information who may not be strictly termed an "insider" within the meaning of Sec. 16(b) of the Act. Thus, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from

disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed. So, it is here no justification for insider activity that disclosure was forbidden by the legitimate corporate objective of acquiring options to purchase the land surrounding the exploration site; if the information was, as the SEC contends, material, its possessors should have kept out of the market until disclosure was accomplished.

B. *Material Inside Information*

An insider is not, of course, always foreclosed from investing in his own company merely because he may be more familiar with company operations than are outside investors. . . . The only regulatory objective is that access to material information be enjoyed equally, but this objective requires nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative expertise in reaching their own investment decisions with knowledge equal to that of the insiders. …

In each case, then, whether facts are material within Rule 10b-5 when the facts relate to a particular event and are undisclosed by those persons who are knowledgeable thereof will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity. Here, notwithstanding the trial court's conclusion that the results of the first drill core, K-55-1, were "too 'remote' to have had any significant impact on the market, i.e., to be deemed material," knowledge of the possibility, which surely was more than marginal, of the existence of a mine of the vast magnitude indicated by the remarkably rich drill core located rather close to the surface (suggesting mineability by the less expensive openpit method) within the confines of a large anomaly (suggesting an extensive region of mineralization) might well have affected the price of TGS stock and would certainly have been an important fact to a reasonable, if speculative, investor in deciding whether he should buy, sell, or hold. . . .

Our survey of the facts found conclusively establishes that knowledge of the results of the discovery hole, would have been important to a reasonable investor and might have affected the price of the stock. . . . Testimony revealed that the prices of stocks of other companies, albeit less diversified, smaller firms, had increased substantially solely on the basis of the discovery of good anomalies or even because of the proximity of their lands to the situs of a potentially major strike.

Finally, . . . the timing by those who knew of it of their stock purchases and their purchases of *short-term* calls — purchases in some cases by individuals who had never before purchased calls or even TGS stock — virtually compels the inference that the insiders were influenced by the drilling results. . . .

The core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress that all members of the investing public should be subject to identical market risks, — which market risks include, of course the risk that one's evaluative capacity or one's capital available to put at risk may exceed another's capacity or capital. The insiders here were not trading on an equal footing with the outside investors. They alone were in a position to evaluate the probability and magnitude of what seemed from the outset to be a major ore strike; they alone could invest safely, secure in the expectation that the price of TGS stock would rise substantially in the event such a major strike should materialize, but would decline little, if at all, in the event of failure, for the public, ignorant at the outset of the favorable probabilities would likewise be unaware of the unproductive exploration, and the additional exploration costs would not significantly affect TGS market prices. . . .

We hold, therefore, that all transactions in TGS stock or calls by individuals apprised of the drilling results were made in violation of Rule 10b-5. The geologist Darke possessed undisclosed material information and traded in TGS securities. Therefore we reverse the dismissal of the action as to him and his personal transactions. . . .

As it is our holding that the information acquired after the drilling of K-55-1 was material, we, on the basis of the findings of direct and circumstantial evidence on the issue that the trial court has already expressed, hold that Darke violated Rule 10b-5 (3) and Section 10(b) by "tipping" and we remand, pursuant to the agreement of the parties, for a determination of the appropriate remedy. As Darke's "tippees" are not defendants in this action, we need not decide whether, if they acted with actual or constructive knowledge that the material information was undisclosed, their conduct is as equally violative of the Rule as the conduct of their insider source, though we note that it certainly could be equally reprehensible. . . .

C. *When May Insiders Act*?

Appellant Crawford, who ordered the purchase of TGS stock shortly before the TGS April 16 official announcement, and defendant Coates, who placed orders with and communicated the news to his broker immediately after the official announcement was read at the TGS-called press conference, concede that they were in possession of material information. They contend, however, that their purchases were not proscribed purchases for the news had already been effectively disclosed. We disagree.

Crawford telephoned his orders to his Chicago broker about midnight on April 15 and again at 8:30 in the morning of the 16th, with instructions to buy at the opening of the Midwest Stock Exchange that morning. The trial court's finding that "he sought to, and did, 'beat the news,'" is well documented by the record. The rumors of a major ore strike which had been circulated in Canada and, to a lesser extent, in New York, had been disclaimed by the TGS press release of April 12, which significantly promised the public an official detailed announcement when possibilities had ripened into actualities. . . . Before insiders may act upon material information, such information must have been effectively disclosed in a manner sufficient to insure its availability to the investing public. Particularly here, where a formal announcement to the entire financial news media had been promised in a prior official release known to the media, all insider activity must await dissemination of the promised official announcement. . . .

Assuming that the contents of the official release could instantaneously be acted upon, at the minimum Coates should have waited until the news could reasonably have been expected to appear over the media of widest circulation, the Dow Jones broad tape, rather than hastening to insure an advantage to himself and his broker son-in-law.

II. THE CORPORATE DEFENDANT

[discussion deleted]

Introductory

The SEC argued below and maintains on this appeal that this release painted a misleading and deceptive picture of the drilling progress at the time of its issuance, and hence violated Rule 10b-5(2). . . . [discussion deleted]

We conclude, then, that, having established that the release was issued in a manner reasonably calculated to affect the market price of TGS stock and to influence the investing public, we must remand to the district court to decide whether the release was misleading to the reasonable investor and if found to be misleading, whether the court in its discretion should issue the injunction the SEC seeks.

CONCLUSION

In summary, therefore, we affirm the finding of the court below that appellants Clayton and Crawford have violated Rule 10b-5; we reverse the judgment order entered below dismissing the complaint against appellees Fogarty, Clayton, Mollison, Holyk, Darke, Huntington, and Coates, as we find that they have violated Rule 10b-5. As to these eight individuals we remand so that in accordance with the agreement between the parties the Commission may notice a hearing before the court below to determine the remedies to be applied against them. . . . We reverse the judgment dismissing the complaint against Texas Gulf Sulphur Company, remand the cause as to it for a further determination below, in the light of the approach explicated by us in the foregoing opinion, as to whether, in the exercise of its discretion, the injunction against it which the Commission seeks should be ordered.

Chiarella v. United States

Supreme Court of the United States

445 U.S. 222

November 5, 1979, Argued
March 18, 1980, Decided

JUDGES**:** POWELL, J., delivered the opinion of the Court, in which STEWART, WHITE, REHNQUIST, and STEVENS, JJ., joined. STEVENS, J., filed a concurring opinion. BRENNAN, J., filed an opinion concurring in the judgment. BURGER, C. J., filed a dissenting opinion. BLACKMUN, J., filed a dissenting opinion, in which MARSHALL, J., joined.

MR. JUSTICE POWELL delivered the opinion of the Court.

The question in this case is whether a person who learns from the confidential documents of one corporation that it is planning an attempt to secure control of a second corporation violates § 10 (b) of the Securities Exchange Act of 1934 if he fails to disclose the impending takeover before trading in the target company's securities.

I

Petitioner is a printer by trade. In 1975 and 1976, he worked as a "markup man" in the New York composing room of Pandick Press, a financial printer. Among documents that petitioner handled were five announcements of corporate takeover bids. When these documents were delivered to the printer, the identities of the acquiring and target corporations were concealed by blank spaces or false names. The true names were sent to the printer on the night of the final printing.

The petitioner, however, was able to deduce the names of the target companies before the final printing from other information contained in the documents. Without disclosing his knowledge, petitioner purchased stock in the target companies and sold the shares immediately after the takeover attempts were made public. [1] By this method, petitioner realized a gain of slightly more than $30,000 in the course of 14 months. Subsequently, the Securities and Exchange Commission (Commission or SEC) began an investigation of his trading activities. In May 1977, petitioner entered into a consent decree with the Commission in which he agreed to return his profits to the sellers of the shares. On the same day, he was discharged by Pandick Press.

In January 1978, petitioner was indicted on 17 counts of violating § 10 (b) of the Securities Exchange Act of 1934 (1934 Act) and SEC Rule 10b-5. After petitioner unsuccessfully moved to dismiss the indictment, he was brought to trial and convicted on all counts.

The Court of Appeals for the Second Circuit affirmed petitioner's conviction. 588 F.2d 1358 (1978). We granted certiorari, and we now reverse.

II

Section 10 (b) of the 1934 Act prohibits the use "in connection with the purchase or sale of any security . . . [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." Pursuant to this section, the SEC promulgated Rule 10b-5 which provides in pertinent part: [5]

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> "(a) To employ any device, scheme, or artifice to defraud, [or] . . .

"(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 CFR § 240.10b-5 (1979).

This case concerns the legal effect of the petitioner's silence. The District Court's charge permitted the jury to convict the petitioner if it found that he willfully failed to inform sellers of target company securities that he knew of a forthcoming takeover bid that would make their shares more valuable. In order to decide whether silence in such circumstances violates § 10 (b), it is necessary to review the language and legislative history of that statute as well as its interpretation by the Commission and the federal courts.

Although the starting point of our inquiry is the language of the statute, § 10 (b) does not state whether silence may constitute a manipulative or deceptive device. Section 10 (b) was designed as a catchall clause to prevent fraudulent practices. But neither the legislative history nor the statute itself affords specific guidance for the resolution of this case. When Rule 10b-5 was promulgated in 1942, the SEC did not discuss the possibility that failure to provide information might run afoul of § 10 (b).

The SEC took an important step in the development of § 10 (b) when it held that a broker-dealer and his firm violated that section by selling securities on the basis of undisclosed information obtained from a director of the issuer corporation who was also a registered representative of the brokerage firm. In *Cady, Roberts & Co*., 40 S. E. C. 907 (1961), the Commission decided that a corporate insider must abstain from trading in the shares of his corporation unless he has first disclosed all material inside information known to him. The obligation to disclose or abstain derives from "[an] affirmative duty to disclose material information."

The Commission emphasized that the duty arose from (i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure. [8]

That the relationship between a corporate insider and the stockholders of his corporation gives rise to a disclosure obligation is not a novel twist of the law. At common law, misrepresentation made for the purpose of inducing reliance upon the false statement is fraudulent. But one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information "that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them." In its *Cady, Roberts* decision, the Commission recognized a relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation. This relationship gives rise to a duty to disclose because of the "necessity of preventing a corporate insider from . . . [taking] unfair advantage of the uninformed minority stockholders."

The federal courts have found violations of § 10 (b) where corporate insiders used undisclosed information for their own benefit. *E. g., SEC* v. *Texas Gulf Sulphur Co*., 401 F.2d 833 (CA2 1968). The cases also have emphasized, in accordance with the common-law rule, that "[the] party charged with failing to disclose market information must be under a duty to disclose it." Accordingly, a purchaser of stock who has no duty to a prospective seller because he is neither an insider nor a fiduciary has been held to have no obligation to reveal material facts. . . .

Thus, administrative and judicial interpretations have established that silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10 (b) despite the absence of statutory language or legislative history specifically addressing the legality of nondisclosure. But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction. Application of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information. [12]

III

In this case, the petitioner was convicted of violating § 10 (b) although he was not a corporate insider and he received no confidential information from the target company. Moreover, the "market information" upon which he relied did not concern the earning power or operations of the target company, but only the plans of the acquiring company. Petitioner's use of that information was not a fraud under § 10 (b) unless he was subject to an affirmative duty to disclose it before trading. In this case, the jury instructions failed to specify any such duty. In effect, the trial court instructed the jury that petitioner owed a duty to everyone; to all sellers, indeed, to the market as a whole. The jury simply was told to decide whether petitioner used material, nonpublic information at a time when "he knew other people trading in the securities market did not have access to the same information." . . . .

We cannot affirm petitioner's conviction without recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information. Formulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties, should not be undertaken absent some explicit evidence of congressional intent. . . .

Indeed, the theory upon which the petitioner was convicted is at odds with the Commission's view of § 10 (b) as applied to activity that has the same effect on sellers as the petitioner's purchases. . . .

We see no basis for applying such a new and different theory of liability in this case. . . . Section 10 (b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. We hold that a duty to disclose under § 10 (b) does not arise from the mere possession of nonpublic market information. The contrary result is without support in the legislative history of § 10 (b) and would be inconsistent with the careful plan that Congress has enacted for regulation of the securities markets.

IV

In its brief to this Court, the United States offers an alternative theory to support petitioner's conviction. It argues that petitioner breached a duty to the acquiring corporation when he acted upon information that he obtained by virtue of his position as an employee of a printer employed by the corporation. The breach of this duty is said to support a conviction under § 10 (b) for fraud perpetrated upon both the acquiring corporation and the sellers.

We need not decide whether this theory has merit for it was not submitted to the jury. The jury was instructed that the petitioner employed a scheme to defraud if he "did not disclose . . . material non-public information in connection with the purchases of the stock."

Alternatively, the jury was instructed that it could convict if "Chiarella's alleged conduct of having purchased securities without disclosing material, non-public information would have or did have the effect of operating as a fraud upon a seller." The judge earlier had stated that fraud "embraces all the means which human ingenuity can devise and which are resorted to by one individual to gain an advantage over another by false misrepresentation, suggestions or by suppression of the truth."

The jury instructions demonstrate that petitioner was convicted merely because of his failure to disclose material, non-public information to sellers from whom he bought the stock of target corporations. The jury was not instructed on the nature or elements of a duty owed by petitioner to anyone other than the sellers. Because we cannot affirm a criminal conviction on the basis of a theory not presented to the jury, we will not speculate upon whether such a duty exists, whether it has been breached, or whether such a breach constitutes a violation of § 10 (b).

The judgment of the Court of Appeals is

Reversed.

MR. JUSTICE STEVENS, concurring.

Before liability, civil or criminal, may be imposed for a Rule 10b-5 violation, it is necessary to identify the duty that the defendant has breached. Arguably, when petitioner bought securities in the open market, he violated (a) a duty to disclose owed to the sellers from whom he purchased target company stock and (b) a duty of silence owed to the acquiring companies. I agree with the Court's determination that petitioner owed no duty of disclosure to the sellers, that his conviction rested on the erroneous premise that he did owe them such a duty, and that the judgment of the Court of Appeals must therefore be reversed. . . .

I write simply to emphasize the fact that we have not necessarily placed any stamp of approval on what this petitioner did, nor have we held that similar actions must be considered lawful in the future. Rather, we have merely held that petitioner's criminal conviction cannot rest on the theory that he breached a duty he did not owe.

Dirks v. Securities and Exchange Commission

Supreme Court of the United States

463 U.S. 646

July 1, 1983, Decided

JUDGES: POWELL, J., delivered the opinion of the Court, in which BURGER, C. J., and WHITE, REHNQUIST, STEVENS, and O'CONNOR, JJ., joined. BLACKMUN, J., filed a dissenting opinion, in which BRENNAN and MARSHALL, JJ., joined.

OPINION BY: JUSTICE POWELL delivered the opinion of the Court.

Petitioner Raymond Dirks received material nonpublic information from "insiders" of a corporation with which he had no connection. He disclosed this information to investors who relied on it in trading in the shares of the corporation. The question is whether Dirks violated the antifraud provisions of the federal securities laws by this disclosure.

I

In 1973, Dirks was an officer of a New York broker-dealer firm who specialized in providing investment analysis of insurance company securities to institutional investors. On March 6, Dirks received information from Ronald Secrist, a former officer of Equity Funding of America. Secrist alleged that the assets of Equity Funding, a diversified corporation primarily engaged in selling life insurance and mutual funds, were vastly overstated as the result of fraudulent corporate practices. Secrist also stated that various regulatory agencies had failed to act on similar charges made by Equity Funding employees. He urged Dirks to verify the fraud and disclose it publicly.

Dirks decided to investigate the allegations. He visited Equity Funding's headquarters in Los Angeles and interviewed several officers and employees of the corporation. The senior management denied any wrongdoing, but certain corporation employees corroborated the charges of fraud. Neither Dirks nor his firm owned or traded any Equity Funding stock, but throughout his investigation he openly discussed the information he had obtained with a number of clients and investors. Some of these persons sold their holdings of Equity Funding securities, including five investment advisers who liquidated holdings of more than $16 million.

While Dirks was in Los Angeles, he was in touch regularly with William Blundell, the Wall Street Journal's Los Angeles bureau chief. Dirks urged Blundell to write a story on the fraud allegations. Blundell did not believe, however, that such a massive fraud could go undetected and declined to write the story. He feared that publishing such damaging hearsay might be libelous.

During the 2-week period in which Dirks pursued his investigation and spread word of Secrist's charges, the price of Equity Funding stock fell from $26 per share to less than $15 per share. This led the New York Stock Exchange to halt trading on March 27. Shortly thereafter California insurance authorities impounded Equity Funding's records and uncovered evidence of the fraud. Only then did the Securities and Exchange Commission (SEC) file a complaint against Equity Funding and only then, on April 2, did the Wall Street Journal publish a front-page story based largely on information assembled by Dirks. Equity Funding immediately went into receivership.

The SEC began an investigation into Dirks' role in the exposure of the fraud. After a hearing by an Administrative Law Judge, the SEC found that Dirks had aided and abetted violations of § 17(a) of the Securities Act of 1933, § 10(b) of the Securities Exchange Act of 1934, and SEC Rule 10b-5, 17 CFR § 240.10b-5 (1983), by repeating the allegations of fraud to members of the investment community who later sold their Equity Funding stock. The SEC concluded: "Where 'tippees' -- regardless of their motivation or occupation -- come into possession of material 'corporate information that they know is confidential and know or should know came from a corporate insider,' they must either publicly disclose that information or refrain from trading." (quoting *Chiarella* v. *United States*, 445 U.S. 222, 230, n. 12 (1980)). Recognizing, however, that Dirks "played an important role in bringing [Equity Funding's] massive fraud to light," the SEC only censured him.

Dirks sought review in the Court of Appeals for the District of Columbia Circuit. The court entered judgment against Dirks "for the reasons stated by the Commission in its opinion." Judge Wright, a member of the panel, subsequently

issued an opinion. Judge Robb concurred in the result and Judge Tamm dissented; neither filed a separate opinion. Judge Wright believed that "the obligations of corporate fiduciaries pass to all those to whom they disclose their information before it has been disseminated to the public at large." Alternatively, Judge Wright concluded that, as an employee of a broker-dealer, Dirks had violated "obligations to the SEC and to the public completely independent of any obligations he acquired" as a result of receiving the information.

In view of the importance to the SEC and to the securities industry of the question presented by this case, we granted a writ of certiorari. We now reverse.

II

In the seminal case of *In re Cady, Roberts & Co*., 40 S. E. C. 907 (1961), the SEC recognized that the common law in some jurisdictions imposes on "corporate 'insiders,' particularly officers, directors, or controlling stockholders" an "affirmative duty of disclosure . . . when dealing in securities." *Id*., at 911, and n. 13. The SEC found that not only did breach of this common-law duty also establish the elements of a Rule 10b-5 violation, but that individuals other than corporate insiders could be obligated either to disclose material nonpublic information before trading or to abstain from trading altogether. In *Chiarella*, we accepted the two elements set out in *Cady, Roberts* for establishing a Rule 10b-5 violation: "(i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure." 445 U.S., at 227. In examining whether Chiarella had an obligation to disclose or abstain, the Court found that there is no general duty to disclose before trading on material nonpublic information, and held that "a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information." *Id*., at 235. Such a duty arises rather from the existence of a fiduciary relationship.

Not "all breaches of fiduciary duty in connection with a securities transaction," however, come within the ambit of Rule 10b-5. There must also be "manipulation or deception." In an inside-trading case this fraud derives from the "inherent unfairness involved where one takes advantage" of "information intended to be available only for a corporate purpose and not for the personal benefit of anyone." Thus, an insider will be liable under Rule 10b-5 for inside trading only where he fails to disclose material nonpublic information before trading on it and thus makes "secret profits." *Cady, Roberts, supra*, at 916, n. 31.

III

We were explicit in *Chiarella* in saying that there can be no duty to disclose where the person who has traded on inside information "was not [the corporation's] agent, . . . was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence." 445 U.S., at 232. Not to require such a fiduciary relationship, we recognized, would "[depart] radically from the established doctrine that duty arises from a specific relationship between two parties" and would amount to "recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information." *Id*., at 232, 233. This requirement of a specific relationship between the shareholders and the individual trading on inside information has created analytical difficulties for the SEC and courts in policing tippees who trade on inside information. Unlike insiders who have independent fiduciary duties to both the corporation and its shareholders, the typical tippee has no such relationships. In view of this absence, it has been unclear how a tippee acquires the *Cady, Roberts* duty to refrain from trading on inside information.

A

The SEC's position, as stated in its opinion in this case, is that a tippee "inherits" the *Cady, Roberts* obligation to shareholders whenever he receives inside information from an insider:

"In tipping potential traders, Dirks breached a duty which he had assumed as a result of knowingly receiving confidential information from [Equity Funding] insiders. Tippees such as Dirks who receive non-public, material information from insiders become 'subject to the same duty as [the] insiders.' Such a tippee breaches the fiduciary duty which he assumes from the insider when the tippee knowingly transmits the information to someone who will probably trade on the basis thereof. . . . Presumably, Dirks' informants were entitled to disclose the [Equity Funding] fraud in order to bring it to light and its perpetrators to justice. However, Dirks — standing in their shoes — committed a breach of the fiduciary duty which he had assumed in dealing with them, when he passed the information on to traders."

This view differs little from the view that we rejected as inconsistent with congressional intent in *Chiarella*. In that case, the Court of Appeals agreed with the SEC and affirmed Chiarella's conviction, holding that "*[anyone]* —

corporate insider or not — who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose." *United States* v. *Chiarella*, 588 F.2d 1358, 1365 (CA2 1978) (emphasis in original). Here, the SEC maintains that anyone who knowingly receives nonpublic material information from an insider has a fiduciary duty to disclose before trading.

In effect, the SEC's theory of tippee liability in both cases appears rooted in the idea that the antifraud provisions require equal information among all traders. This conflicts with the principle set forth in *Chiarella* that only some persons, under some circumstances, will be barred from trading while in possession of material nonpublic information. [16] Judge Wright correctly read our opinion in *Chiarella* as repudiating any notion that all traders must enjoy equal information before trading: "[The] 'information' theory is rejected. Because the disclose-or-refrain duty is extraordinary, it attaches only when a party has legal obligations other than a mere duty to comply with the general antifraud proscriptions in the federal securities laws." 220 U. S. App. D. C., at 322, 681 F.2d, at 837. See *Chiarella*, 445 U.S., at 235, n. 20. We reaffirm today that "[a] duty [to disclose] arises from the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market."

Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market. It is commonplace for analysts to "ferret out and analyze information," and this often is done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities. The analyst's judgment in this respect is made available in market letters or otherwise to clients of the firm. It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or the public generally.

B

The conclusion that recipients of inside information do not invariably acquire a duty to disclose or abstain does not mean that such tippees always are free to trade on the information. The need for a ban on some tippee trading is clear. Not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they also may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain. Similarly, the transactions of those who knowingly participate with the fiduciary in such a breach are "as forbidden" as transactions "on behalf of the trustee himself." Thus, the tippee's duty to disclose or abstain is derivative from that of the insider's duty. As we noted in *Chiarella*, "[the] tippee's obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty."

Thus, some tippees must assume an insider's duty to the shareholders not because they receive inside information, but rather because it has been made available to them *improperly*. And for Rule 10b-5 purposes, the insider's disclosure is improper only where it would violate his *Cady, Roberts* duty. Thus, a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach. . . . Tipping thus properly is viewed only as a means of indirectly violating the *Cady, Roberts* disclose-or-abstain rule.

C

In determining whether a tippee is under an obligation to disclose or abstain, it thus is necessary to determine whether the insider's "tip" constituted a breach of the insider's fiduciary duty. All disclosures of confidential corporate information are not inconsistent with the duty insiders owe to shareholders. In contrast to the extraordinary facts of this case, the more typical situation in which there will be a question whether disclosure violates the insider's *Cady, Roberts* duty is when insiders disclose information to analysts. In some situations, the insider will act consistently with his fiduciary duty to shareholders, and yet release of the information may affect the market. For example, it may not be clear — either to the corporate insider or to the recipient analyst -- whether the information will be viewed as material nonpublic information. Corporate officials may mistakenly think the information already has been disclosed or that it is not material enough to affect the market. Whether disclosure is a breach of duty therefore depends in large part on the purpose of the disclosure. . . . Thus, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.

The SEC argues that, if inside-trading liability does not exist when the information is transmitted for a proper purpose but is used for trading, it would be a rare situation when the parties could not fabricate some ostensibly legitimate business justification for transmitting the information. We think the SEC is unduly concerned. In determining whether the insider's purpose in making a particular disclosure is fraudulent, the SEC and the courts are not required to read the parties' minds. Scienter in some cases is relevant in determining whether the tipper has violated his *Cady, Roberts* duty. But to determine whether the disclosure itself "[deceives], [manipulates], or [defrauds]" shareholders, the initial inquiry is whether there has been a breach of duty by the insider. This requires courts to focus on objective criteria, *i. e*., whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings. . . . There are objective facts and circumstances that often justify such an inference. For example, there may be a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient. The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.

Determining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts. But it is essential, we think, to have a guiding principle for those whose daily activities must be limited and instructed by the SEC's inside-trading rules, and we believe that there must be a breach of the insider's fiduciary duty before the tippee inherits the duty to disclose or abstain. In contrast, the rule adopted by the SEC in this case would have no limiting principle.

IV

Under the inside-trading and tipping rules set forth above, we find that there was no actionable violation by Dirks. It is undisputed that Dirks himself was a stranger to Equity Funding, with no pre-existing fiduciary duty to its shareholders. He took no action, directly or indirectly, that induced the shareholders or officers of Equity Funding to repose trust or confidence in him. There was no expectation by Dirks' sources that he would keep their information in confidence. Nor did Dirks misappropriate or illegally obtain the information about Equity Funding. Unless the insiders breached their *Cady, Roberts* duty to shareholders in disclosing the nonpublic information to Dirks, he breached no duty when he passed it on to investors as well as to the Wall Street Journal.

It is clear that neither Secrist nor the other Equity Funding employees violated their *Cady, Roberts* duty to the corporation's shareholders by providing information to Dirks. The tippers received no monetary or personal benefit for revealing Equity Funding's secrets, nor was their purpose to make a gift of valuable information to Dirks. As the facts of this case clearly indicate, the tippers were motivated by a desire to expose the fraud. In the absence of a breach of duty to shareholders by the insiders, there was no derivative breach by Dirks. Dirks therefore could not have been "a participant after the fact in [an] insider's breach of a fiduciary duty." *Chiarella*, 445 U.S., at 230, n. 12.

V

We conclude that Dirks, in the circumstances of this case, had no duty to abstain from use of the inside information that he obtained. The judgment of the Court of Appeals therefore is

Reversed.

DISSENT BY: JUSTICE BLACKMUN, with whom JUSTICE BRENNAN and JUSTICE MARSHALL join, dissenting.

Carpenter et al. v. United States

Supreme Court Of The United States

484 U.S. 19

October 7, 1987, Argued
November 16, 1987, Decided

WHITE, J., delivered the opinion for a unanimous Court

JUSTICE WHITE delivered the opinion of the Court.

Petitioners Kenneth Felis and R. Foster Winans were convicted of violating § 10(b) of the Securities Exchange Act of 1934 [1] and Rule 10b-5. [2] They were also found guilty of violating the federal mail and wire fraud statutes, and were convicted for conspiracy. Petitioner David Carpenter, Winans' roommate, was convicted for aiding and abetting. With a minor exception, the Court of Appeals for the Second Circuit affirmed; we granted certiorari.

I

In 1981, Winans became a reporter for the Wall Street Journal (the Journal) and in the summer of 1982 became one of the two writers of a daily column, "Heard on the Street." That column discussed selected stocks or groups of stocks, giving positive and negative information about those stocks and taking "a point of view with respect to investment in the stocks that it reviews." Winans regularly interviewed corporate executives to put together interesting perspectives on the stocks that would be highlighted in upcoming columns, but, at least for the columns at issue here, none contained corporate inside information or any "hold for release" information. Because of the "Heard " column's perceived quality and integrity, it had the potential of affecting the price of the stocks which it examined. The District Court concluded on the basis of testimony presented at trial that the "Heard" column "does have an impact on the market, difficult though it may be to quantify in any particular case."

The official policy and practice at the Journal was that prior to publication, the contents of the column were the Journal's confidential information. Despite the rule, with which Winans was familiar, he entered into a scheme in October 1983 with Peter Brant and petitioner Felis, both connected with the Kidder Peabody brokerage firm in New York City, to give them advance information as to the timing and contents of the "Heard" column. This permitted Brant and Felis and another conspirator, David Clark, a client of Brant, to buy or sell based on the probable impact of the column on the market. Profits were to be shared. The conspirators agreed that the scheme would not affect the journalistic purity of the "Heard" column, and the District Court did not find that the contents of any of the articles were altered to further the profit potential of petitioners' stock-trading scheme. Over a 4-month period, the brokers made prepublication trades on the basis of information given them by Winans about the contents of some 27 "Heard" columns. The net profits from these trades were about $690,000.

In November 1983, correlations between the "Heard" articles and trading in the Clark and Felis accounts were noted at Kidder Peabody and inquiries began. Brant and Felis denied knowing anyone at the Journal and took steps to conceal the trades. Later, the Securities and Exchange Commission began an investigation. Questions were met by denials both by the brokers at Kidder Peabody and by Winans at the Journal. As the investigation progressed, the conspirators quarreled, and on March 29, 1984, Winans and Carpenter went to the SEC and revealed the entire scheme. This indictment and a bench trial followed. Brant, who had pleaded guilty under a plea agreement, was a witness for the Government.

The District Court found, and the Court of Appeals agreed, that Winans had knowingly breached a duty of confidentiality by misappropriating prepublication information regarding the timing and contents of the "Heard" column, information that had been gained in the course of his employment under the understanding that it would not be revealed in advance of publication and that if it were, he would report it to his employer. It was this appropriation of confidential information that underlay both the securities laws and mail and wire fraud counts. With respect to the §10(b) charges, the courts below held that the deliberate breach of Winans' duty of confidentiality and concealment of the scheme was a fraud and deceit on the Journal. Although the victim of the fraud, the Journal, was not a buyer or seller of the stocks traded in or otherwise a market participant, the fraud was nevertheless considered to be "in

connection with" a purchase or sale of securities within the meaning of the statute and the rule. The courts reasoned that the scheme's sole purpose was to buy and sell securities at a profit based on advance information of the column's contents. The courts below rejected petitioners' submission, which is one of the two questions presented here, that criminal liability could not be imposed on petitioners under Rule 10b-5 because "the newspaper is the only alleged victim of fraud and has no interest in the securities traded." . . .

The Court is evenly divided with respect to the convictions under the securities laws and for that reason affirms the judgment below on those counts. For the reasons that follow, we also affirm the judgment with respect to the mail and wire fraud convictions.

II

Petitioners assert that their activities were not a scheme to defraud the Journal within the meaning of the mail and wire fraud statutes; and that in any event, they did not obtain any "money or property" from the Journal. We are unpersuaded by either submission and address the latter first.

The Journal, as Winans' employer, was defrauded of much more than its contractual right to his honest and faithful service, an interest too ethereal in itself to fall within the protection of the mail fraud statute, which "had its origin in the desire to protect individual property rights." Here, the object of the scheme was to take the Journal's confidential business information — the publication schedule and contents of the "Heard" column — and its intangible nature does not make it any less "property" protected by the mail and wire fraud statutes.

Confidential business information has long been recognized as property. The Journal had a property right in keeping confidential and making exclusive use, prior to publication, of the schedule and contents of the "Heard " column. . . . Petitioners' arguments that they did not interfere with the Journal's use of the information or did not publicize it and deprive the Journal of the first public use of it, miss the point. The confidential information was generated from the business, and the business had a right to decide how to use it prior to disclosing it to the public. Petitioners cannot successfully contend that a scheme to defraud requires a monetary loss, such as giving the information to a competitor; it is sufficient that the Journal has been deprived of its right to exclusive use of the information, for exclusivity is an important aspect of confidential business information and most private property for that matter.

We cannot accept petitioners' further argument that Winans' conduct in revealing prepublication information was no more than a violation of workplace rules and did not amount to fraudulent activity. . . . The concept of "fraud" includes the act of embezzlement, which is "'the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another.'" . . . .

We have little trouble in holding that the conspiracy here to trade on the Journal's confidential information is not outside the reach of the mail and wire fraud statutes, provided the other elements of the offenses are satisfied. The Journal's business information that it intended to be kept confidential was its property; the declaration to that effect in the employee manual merely removed any doubts on that score and made the finding of specific intent to defraud that much easier. Winans continued in the employ of the Journal, appropriating its confidential business information for his own use, all the while pretending to perform his duty of safeguarding it. In fact, he told his editors twice about leaks of confidential information not related to the stock-trading scheme, demonstrating both his knowledge that the Journal viewed information concerning the "Heard" column as confidential and his deceit as he played the role of a loyal employee. Furthermore, the District Court's conclusion that each of the petitioners acted with the required specific intent to defraud is strongly supported by the evidence.

Lastly, we reject the submission that using the wires and the mail to print and send the Journal to its customers did not satisfy the requirement that those mediums be used to execute the scheme at issue. The courts below were quite right in observing that circulation of the "Heard" column was not only anticipated but an essential part of the scheme. Had the column not been made available to Journal customers, there would have been no effect on stock prices and no likelihood of profiting from the information leaked by Winans.

The judgment below is *Affirmed*.

Stoneridge Investment Partners, LLLC, Petitioner v. Scientific-Atlanta, Inc., et al.

Supreme Court of the United States

552 U.S. 148; 128 S. Ct. 761

January 15, 2008, Decided

JUDGES: Kennedy, J., delivered the opinion of the Court, in which Roberts, C. J., and Scalia, Thomas, and Alito, JJ., joined. Stevens, J., filed a dissenting opinion, in which Souter and Ginsburg, JJ., joined. Breyer, J., took no part in the consideration or decision of the case.

Justice Kennedy delivered the opinion of the Court.

We consider the reach of the private right of action the Court has found implied in § 10(b) of the Securities Exchange Act of 1934. In this suit investors alleged losses after purchasing common stock. They sought to impose liability on entities who, acting both as customers and suppliers, agreed to arrangements that allowed the investors' company to mislead its auditor and issue a misleading financial statement affecting the stock price. We conclude the implied right of action does not reach the customer/supplier companies because the investors did not rely upon their statements or representations. We affirm the judgment of the Court of Appeals.

I

This class-action suit by investors was filed against Charter Communications, Inc., in the United States District Court for the Eastern District of Missouri. Stoneridge Investment Partners, LLC, a limited liability company organized under the laws of Delaware, was the lead plaintiff and is petitioner here.

Charter issued the financial statements and the securities in question. It was a named defendant along with some of its executives and Arthur Andersen LLP, Charter's independent auditor during the period in question. We are concerned, though, with two other defendants, respondents here. Respondents are Scientific-Atlanta, Inc., and Motorola, Inc. They were suppliers, and later customers, of Charter.

For purposes of this proceeding, we take these facts, alleged by petitioner, to be true. Charter, a cable operator, engaged in a variety of fraudulent practices so its quarterly reports would meet Wall Street expectations for cable subscriber growth and operating cashflow. The fraud included misclassification of its customer base; delayed reporting of terminated customers; improper capitalization of costs that should have been shown as expenses; and manipulation of the company's billing cutoff dates to inflate reported revenues. In late 2000, Charter executives realized that, despite these efforts, the company would miss projected operating cashflow numbers by $15 to $20 million. To help meet the shortfall, Charter decided to alter its existing arrangements with respondents, Scientific-Atlanta and Motorola. In our decision we assume Arthur Andersen was misled.

Respondents supplied Charter with the digital cable converter (set top) boxes that Charter furnished to its customers. Charter arranged to overpay respondents $20 for each set top box it purchased until the end of the year, with the understanding that respondents would return the overpayment by purchasing advertising from Charter. The transactions, it is alleged, had no economic substance; but, because Charter would then record the advertising purchases as revenue and capitalize its purchase of the set top boxes, in violation of generally accepted accounting principles, the transactions would enable Charter to fool its auditor into approving a financial statement showing it met projected revenue and operating cashflow numbers. Respondents agreed to the arrangement.

So that Arthur Andersen would not discover the link between Charter's increased payments for the boxes and the advertising purchases, the companies drafted documents to make it appear the transactions were unrelated and conducted in the ordinary course of business. Following a request from Charter, Scientific-Atlanta sent documents to Charter stating—falsely—that it had increased production costs. It raised the price for set top boxes for the rest of 2000 by $20 per box. As for Motorola, in a written contract Charter agreed to purchase from Motorola a specific number of set top boxes and pay liquidated damages of $20 for each unit it did not take. The contract was made with the expectation Charter would fail to purchase all the units and pay Motorola the liquidated damages.

To return the additional money from the set top box sales, Scientific-Atlanta and Motorola signed contracts with Charter to purchase advertising time for a price higher than fair value. The new set top box agreements were backdated to make it appear that they were negotiated a month before the advertising agreements. The backdating was important to convey the impression that the negotiations were unconnected, a point Arthur Andersen considered necessary for separate treatment of the transactions. Charter recorded the advertising payments to inflate revenue and operating cashflow by approximately $17 million. The inflated number was shown on financial statements filed with the Securities and Exchange Commission (SEC) and reported to the public.

Respondents [Scientific-Atlanta, Inc., and Motorola, Inc.] had no role in preparing or disseminating Charter's financial statements. And their own financial statements booked the transactions as a wash, under generally accepted accounting principles. It is alleged respondents knew or were in reckless disregard of Charter's intention to use the transactions to inflate its revenues and knew the resulting financial statements issued by Charter would be relied upon by research analysts and investors.

Petitioner filed a securities fraud class action on behalf of purchasers of Charter stock alleging that, by participating in the transactions, respondents violated § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. . . .

Decisions of the Courts of Appeals are in conflict respecting when, if ever, an injured investor may rely upon § 10(b) to recover from a party that neither makes a public misstatement nor violates a duty to disclose but does participate in a scheme to violate § 10(b). We granted certiorari.

II

Section 10(b) of the Securities Exchange Act makes it:

> "unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange. . . . .
>
> "[t]o 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 and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78j.

The SEC, pursuant to this section, promulgated Rule 10b-5, which makes it unlawful:

> "(a) To employ any device, scheme, or artifice to defraud,
>
> "(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> "(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> "in connection with the purchase or sale of any security." 17 CFR § 240.10b-5.

Rule 10b-5 encompasses only conduct already prohibited by § 10(b). Though the text of the Securities Exchange Act does not provide for a private cause of action for § 10(b) violations, the Court has found a right of action implied in the words of the statute and its implementing regulation. In a typical § 10(b) private action a plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.

In *Central Bank*, the Court determined that § 10(b) liability did not extend to aiders and abettors. The Court found the scope of § 10(b) to be delimited by the text, which makes no mention of aiding and abetting liability. The Court doubted the implied § 10(b) action should extend to aiders and abettors when none of the express causes of action in the securities Acts included that liability. . . .

The decision in *Central Bank* led to calls for Congress to create an express cause of action for aiding and abetting within the Securities Exchange Act. Then-SEC Chairman Arthur Levitt, testifying before the Senate Securities Subcommittee, cited *Central Bank* and recommended that aiding and abetting liability in private claims be established. Congress did not follow this course. . . . Instead, it directed prosecution of aiders and abettors by the SEC.

The § 10(b) implied private right of action does not extend to aiders and abettors. The conduct of a secondary actor must satisfy each of the elements or preconditions for liability; and we consider whether the allegations here are sufficient to do so.

III

Reliance by the plaintiff upon the defendant's deceptive acts is an essential element of the § 10(b) private cause of action. It ensures that, for liability to arise, the "requisite causal connection between a defendant's misrepresentation and a plaintiff's injury" exists as a predicate for liability. We have found a rebuttable presumption of reliance in two different circumstances. First, if there is an omission of a material fact by one with a duty to disclose, the investor to whom the duty was owed need not provide specific proof of reliance. Second, under the fraud-on-the-market doctrine, reliance is presumed when the statements at issue become public. The public information is reflected in the market price of the security. Then it can be assumed that an investor who buys or sells stock at the market price relies upon the statement.

Neither presumption applies here. Respondents had no duty to disclose; and their deceptive acts were not communicated to the public. No member of the investing public had knowledge, either actual or presumed, of respondents' deceptive acts during the relevant times. Petitioner, as a result, cannot show reliance upon any of respondents' actions except in an indirect chain that we find too remote for liability.

In effect petitioner contends that in an efficient market investors rely not only upon the public statements relating to a security but also upon the transactions those statements reflect. Were this concept of reliance to be adopted, the implied cause of action would reach the whole marketplace in which the issuing company does business; and there is no authority for this rule.

As stated above, reliance is tied to causation, leading to the inquiry whether respondents' acts were immediate or remote to the injury. In all events we conclude respondents' deceptive acts, which were not disclosed to the investing public, are too remote to satisfy the requirement of reliance. It was Charter, not respondents, that misled its auditor and filed fraudulent financial statements; nothing respondents did made it necessary or inevitable for Charter to record the transactions as it did.

These considerations answer as well the argument that if this were a common-law action for fraud there could be a finding of reliance. Even if the assumption is correct, it is not controlling. Section 10(b) does not incorporate common-law fraud into federal law.

The history of the § 10(b) private right and the careful approach the Court has taken before proceeding without congressional direction provide further reasons to find no liability here.

Concerns with the judicial creation of a private cause of action caution against its expansion. The decision to extend the cause of action is for Congress, not for us. Though it remains the law, the § 10(b) private right should not be extended beyond its present boundaries.

Secondary actors are subject to criminal penalties. The enforcement power is not toothless. Since 2002, SEC enforcement actions have collected over $10 billion in disgorgement and penalties for distribution to injured investors.

Here respondents were acting in concert with Charter in the ordinary course as suppliers and, as matters then evolved in the not so ordinary course, as customers. Unconventional as the arrangement was, it took place in the marketplace for goods and services, not in the investment sphere. Charter was free to do as it chose in preparing its books, conferring with its auditor, and preparing and then issuing its financial statements. In these circumstances the investors cannot be said to have relied upon any of respondents' deceptive acts in the decision to purchase or sell securities; and as the requisite reliance cannot be shown, respondents have no liability to petitioner under the implied right of action. This conclusion is consistent with the narrow dimensions we must give to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law.

The judgment of the Court of Appeals is affirmed, and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

Justice Breyer took no part in the consideration or decision of this case.

DISSENT BY: STEVENS

Justice Stevens, with whom Justice Souter and Justice Ginsburg join, dissenting.

Charter Communications, Inc., inflated its revenues by $17 million in order to cover up a $15 to $20 million expected cashflow shortfall. It could not have done so absent the knowingly fraudulent actions of Scientific-Atlanta, Inc., and

Motorola, Inc. Investors relied on Charter's revenue statements in deciding whether to invest in Charter and in doing so relied on respondents' fraud, which was itself a "deceptive device" prohibited by § 10(b) of the Securities Exchange Act of 1934. . . .

Even if but-for causation, standing alone, is too weak to establish reliance, petitioner has also alleged that respondents proximately caused Charter's misstatement of income; petitioner has alleged that respondents knew their deceptive acts would be the basis for statements that would influence the market price of Charter stock on which shareholders would rely. . . .

While I would reverse for the reasons stated above, I must also comment on the importance of the private cause of action that Congress implicitly authorized when it enacted the Securities Exchange Act of 1934. . . .

During the first two centuries of this Nation's history much of our law was developed by judges in the common-law tradition. A basic principle animating our jurisprudence was enshrined in state constitution provisions guaranteeing, in substance, that "every wrong shall have a remedy." Fashioning appropriate remedies for the violation of rules of law designed to protect a class of citizens was the routine business of judges. . . .

That context persuaded the majority that Congress had intended the courts to authorize a private remedy for members of the protected class. . . .

In light of the history of court-created remedies and specifically the history of implied causes of action under § 10(b), the Court is simply wrong when it states that Congress did not impliedly authorize this private cause of action "when it first enacted the statute." . . . . Congress enacted § 10(b) with the understanding that federal courts respected the principle that every wrong would have a remedy. Today's decision simply cuts back further on Congress' intended remedy. I respectfully dissent.

VI. ACCOUNTANTS LIABILITY

Credit Alliance Corporation et al., Respondents, v. Arthur Andersen & Co., Appellant

Court of Appeals of New York

65 N.Y.2d 536; 483 N.E.2d 110

July 2, 1985, Decided

JUDGES: Chief Judge Wachtler and Judges Meyer, Simons, Kaye, Titone and Boomer concur.

OPINION BY: Jasen, J.

The critical issue common to these two appeals is whether an accountant may be held liable, absent privity of contract, to a party who relies to his detriment upon a negligently prepared financial report and, if so, within what limits does that liability extend.

I

Plaintiffs are major financial service companies engaged primarily in financing the purchase of capital equipment through installment sales or leasing agreements. Defendant, Arthur Andersen & Co. ("Andersen"), is a national accounting firm. Plaintiffs' complaint and affidavit allege that prior to 1978, plaintiffs had provided financing to L. B. Smith, Inc. of Virginia ("Smith"), a capital intensive enterprise that regularly required financing. During 1978, plaintiffs advised Smith that as a condition to extending additional major financing, they would insist upon examining an audited financial statement. Accordingly, Smith provided plaintiffs with its consolidated financial statements, covering both itself and its subsidiaries, "For The Years Ended December 31, 1977 and 1976" (the "1977 statements"). These statements contained an auditor's report prepared by Andersen stating that it had examined the statements in accordance with generally accepted auditing standards ("GAAS") and found them to reflect fairly the financial position of Smith in conformity with generally accepted accounting principles ("GAAP"). In reliance upon the 1977 statements, plaintiffs provided substantial amounts in financing to Smith through various extensions of credit. Thereafter, in 1979, as a precondition to continued financing, plaintiffs requested and received from Smith the consolidated financial statements "For The Years Ended February 28, 1979 and December 31, 1977" (the "1979 statements"). Again, Andersen's report vouched for its examination of the financial statements and the financial position of Smith reflected therein. Relying upon these certified statements, plaintiffs provided additional substantial financing to Smith.

It is alleged that both statements overstated Smith's assets, net worth and general financial health, and that Andersen failed to conduct investigations in accordance with proper auditing standards, thereby failing to discover Smith's precarious financial condition and the serious possibility that Smith would be unable to survive as a going concern. Indeed, in 1980, Smith filed a petition for bankruptcy. By that time, Smith had already defaulted on several millions of dollars of obligations to plaintiffs.

In August 1981, plaintiffs commenced this suit for damages lost on its outstanding loans to Smith, claiming both negligence and fraud by Andersen in the preparation of its audit reports. The complaint alleges that Andersen knew, should have known or was on notice that the 1977 and 1979 certified statements were being utilized by Smith to induce companies such as plaintiffs to make credit available to Smith. The complaint further states that Andersen knew, should have known or was on notice that the certified statements were being shown to plaintiffs for such a purpose. It is also alleged that Andersen knew or recklessly disregarded facts which indicated that the 1977 and 1979 statements were misleading.

On appeal, the Appellate Division affirmed the order below, holding, in part, that despite the absence of contractual privity between the parties, plaintiffs were members of a limited class whose reliance upon the financial statements should have been specifically foreseen by defendants. The court concluded that plaintiffs fell within the exception to the general rule that requires privity to maintain an action against an accountant for negligence. Two Justices dissented on the ground that the rule requiring privity has been repeatedly reaffirmed by this court and mandates dismissal of the action for negligence.

The Appellate Division granted Andersen's motion for leave to appeal to this court and certified the following question: "Was the order of the Supreme Court, as affirmed by this Court, properly made?" Because the allegations in plaintiffs'

complaint and affidavit fail to set forth either a relationship of contractual privity with Andersen or a relationship sufficiently intimate to be equated with privity, the first cause of action should be dismissed. Further, inasmuch as plaintiffs' second cause of action, sounding in fraud, comprises mere conclusory allegations, it also should be dismissed. Accordingly, we now reverse and answer the certified question in the negative. . . .

II

In the seminal case of *Ultramares Corp. v Touche* (255 NY 170), this court, speaking through the opinion of Chief Judge Cardozo more than 50 years ago, disallowed a cause of action in negligence against a public accounting firm for inaccurately prepared financial statements which were relied upon by a plaintiff having no contractual privity with the accountants. . . . This court has subsequently reaffirmed its holding in *Ultramares* which has been, and continues to be, much discussed and analyzed by the commentators and by the courts of other jurisdictions. These appeals now provide us with the opportunity to reexamine and delineate the principles enunciated in *Ultramares*. Inasmuch as we believe that a relationship "so close as to approach that of privity" remains valid as the predicate for imposing liability upon accountants to noncontractual parties for the negligent preparation of financial reports, we restate and elaborate upon our adherence to that standard today. . . .

This court could note in *Ultramares* that the "assault upon the citadel of privity is proceeding in these days apace." Indeed, we referred to this court's holding in *MacPherson v Buick Motor Co*. (217 NY 382) where it was decided that the manufacturer of a defective chattel — there an automobile — may be liable in negligence for the resulting injuries sustained by a user regardless of the absence of privity — a belated rejection of the doctrine of privity. Nevertheless, regarding an accountant's liability to unknown parties with whom he had not contracted, the considerations were deemed sufficiently dissimilar to justify different treatment.

Although accountants might be held liable in fraud to nonprivy parties who were intended to rely upon the accountants' misrepresentations, we noted that "[a] different question develops when we ask whether they owed a duty to these to make [their reports] without negligence." (*Ultramares Corp. v Touche, supra*, at p 179.) Disputing the wisdom of extending the duty of care of accountants to anyone who might foreseeably rely upon their financial reports, Cardozo, speaking for this court, remarked: "If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences."

In *Ultramares*, the accountants had prepared a certified balance sheet for their client to whom they provided 32 copies. The client, in turn, gave one to the plaintiff company. The latter, relying upon the misinformation contained in the balance sheet, made loans to the accountants' client who, only months later, was declared bankrupt. This court, refusing to extend the accountants' liability for negligence to their client's lender, with whom they had no contractual privity, noted that the accountants had prepared a report on behalf of their client to be exhibited generally to "banks, creditors, stockholders, purchasers or sellers, *according to the needs of the occasion*". [emphasis added].) In reciting the facts, we emphasized that: "*Nothing was said as to the persons to whom these [copies] would be shown or the extent or number of the transactions in which they would be used.* In particular there was no mention of the plaintiff, a corporation doing business chiefly as a factor, which till then had never made advances to the [accountants' client], though it had sold merchandise in small amounts. The range of the transactions in which a certificate of audit might be expected to play a part was as indefinite and wide as the possibilities of the business that was mirrored in the summary." [emphasis added].)

The accountants' report was primarily intended as a convenient instrumentality for the client's use in developing its business. "[Only] incidentally or collaterally" was it expected to assist those to whom the client "might exhibit it thereafter". Under such circumstances, permitting recovery by parties such as the plaintiff company would have been to impose a duty upon accountants "[enforceable] by any member of an indeterminate class of creditors, present and prospective, known and unknown." . . . .

Several years subsequent to the decision in *Ultramares*, this court reiterated the requirement for a "contractual relationship or its equivalent" (*State St. Trust Co. v Ernst*, 278 NY 104, 111), and more recently, in *White v Guarente* (43 NY2d 356), such an equivalent was presented for our consideration. There, the accountants had contracted with a limited partnership to perform an audit and prepare the partnership's tax returns. The nature and purpose of the contract, to satisfy the requirement in the partnership agreement for an audit, made it clear that the accountants' services were obtained to benefit the members of the partnership who, like plaintiff, a limited partner, were necessarily dependent

upon the audit to prepare their own tax returns. After outlining the principles articulated in *Ultramares* and *Glanzer*, this court observed that: "[This] plaintiff seeks redress, not as a mere member of the public, but as one of a settled and particularized class among the members of which the report would be circulated *for the specific purpose of fulfilling the limited partnership agreed upon arrangement*." [emphasis added].) Because the accountants knew that a limited partner would have to rely upon the audit and tax returns of the partnership, and inasmuch as this was within the specific contemplation of the accounting retainer, we held that, "at least on the facts here, an accountant's liability may be so imposed." The resulting relationship between the accountants and the limited partner was clearly one "[approaching] that of privity, if not completely one with it." (*Ultramares Corp. v Touche, supra*, at p 183.)

Upon examination of *Ultramares* and *Glanzer* and our recent affirmation of their holdings in *White*, certain criteria may be gleaned. Before accountants may be held liable in negligence to noncontractual parties who rely to their detriment on inaccurate financial reports, certain prerequisites must be satisfied: (1) the accountants must have been aware that the financial reports were to be used for a particular purpose or purposes; (2) in the furtherance of which a known party or parties was intended to rely; and (3) there must have been some conduct on the part of the accountants linking them to that party or parties, which evinces the accountants' understanding of that party or parties' reliance. While these criteria permit some flexibility in the application of the doctrine of privity to accountants' liability, they do not represent a departure from the principles articulated in *Ultramares, Glanzer* and *White*, but, rather, they are intended to preserve the wisdom and policy set forth therein.

We are aware that the courts throughout this country are divided as to the continued validity of the holding in *Ultramares*. Some courts continue to insist that a strict application of the privity requirement governs the law of accountants' liability except, perhaps, where special circumstances compel a different result. . . . On the other hand, an increasing number of courts have adopted what they deem to be a more flexible approach than that permitted under this court's past decisions. . . .

To the extent, however, that those cases were decided upon the ground that *Ultramares* should not be followed and, instead, a rule permitting recovery by any foreseeable plaintiff should be adopted, the law in this State, as reiterated today, is clearly distinguishable.

III

In the appeal we decide today, application of the foregoing principles presents little difficulty. In *Credit Alliance*, the facts as alleged by plaintiffs fail to demonstrate the existence of a relationship between the parties sufficiently approaching privity. Though the complaint and supporting affidavit do allege that Andersen specifically knew, should have known or was on notice that plaintiffs were being shown the reports by Smith, Andersen's client, in order to induce their reliance thereon, nevertheless, there is no adequate allegation of either a particular purpose for the reports' preparation or the prerequisite conduct on the part of the accountants. While the allegations state that Smith sought to induce plaintiffs to extend credit, no claim is made that Andersen was being employed to prepare the reports with that particular purpose in mind. Moreover, there is no allegation that Andersen had any direct dealings with plaintiffs, had specifically agreed with Smith to prepare the report for plaintiffs' use or according to plaintiffs' requirements, or had specifically agreed with Smith to provide plaintiffs with a copy or actually did so. Indeed, there is simply no allegation of any word or action on the part of Andersen directed to plaintiffs, or anything contained in Andersen's retainer agreement with Smith which provided the necessary link between them. . . .

Accordingly, in *Credit Alliance* both causes of action should be dismissed, the order of the Appellate Division reversed, with costs, and the certified question answered in the negative.

Order reversed.

Harry Rosenblum, and Barry Rosenblum, Plaintiffs-Appellants, v. Touche Ross & Co., Defendant-Respondent

Supreme Court of New Jersey

93 N.J. 324; 461 A.2d 138 (1983)

June 9, 1983, Decided

OPINION BY: SCHREIBER

This case focuses upon the issue of whether accountants should be responsible for their negligence in auditing financial statements. If so, we must decide whether a duty is owed to those with whom the auditor is in privity, to third persons known and intended by the auditor to be the recipients of the audit, and to those who foreseeably might rely on the audit. Subsumed within these questions is a more fundamental one: to what extent does public policy justify imposition of a duty to any of these classes?

I.

The plaintiffs Harry and Barry Rosenblum brought this action against Touche Ross & Co. (Touche), a partnership, and the individual partners. Touche, a prominent accounting firm, had audited the financial statements of Giant Stores Corporation (Giant). These plaintiffs, allegedly relying on the correctness of the audits, acquired Giant common stock in conjunction with the sale of their business to Giant. That stock subsequently proved to be worthless, after the financial statements were found to be fraudulent. Plaintiffs claim that Touche negligently conducted the audits and that Touche's negligence was a proximate cause of their loss.

Giant, a Massachusetts corporation, operated discount department stores, retail catalog showrooms and art and gift shops. Its common stock was publicly traded, its initial public offering having been made pursuant to a registration statement filed with the Securities and Exchange Commission (SEC) in 1969. Giant was required to file audited financial statements with the SEC as part of its annual report to stockholders and Touche conducted those audit examinations during the fiscal years 1969 through 1972.

In November 1971, Giant commenced negotiations with the plaintiffs for the acquisition of their businesses in New Jersey. The merger negotiations culminated in an agreement executed on March 9, 1972. During the discussions two significant events occurred. First, on December 14, 1971, Giant made a public offering of 360,000 shares of its common stock. The financial statements included in the prospectus of that offering contained statements of annual earnings for four years ending January 30, 1971, as well as balance sheets as of January 30 for each of those years, which had been audited by Touche. Touche's opinion affixed to those financials stated that it had examined the statements of earnings and balance sheets "in accordance with generally accepted auditing standards" and that the financial statements "present[ed] fairly" Giant's financial position. Similar data had been incorporated in Giant's annual report for the year ending January 30, 1971. Second, Touche began its audit of Giant's financials for the year ending January 29, 1972. The attached Touche opinion bore the same language affixed to the 1971 statements." . . .

The merger agreement provided that the Rosenblums would receive an amount of Giant stock, up to a maximum of 86,075 shares, depending upon the net income of their enterprises for their fiscal year ending December 31, 1971. . . The plaintiffs claim they relied upon the 1972 audited statements before closing the transaction on June 12, 1972. The Rosenblums received Giant common stock, which had been listed on the American Stock Exchange in February 1972 and was being traded on that Exchange when the merger was effected. After the Rosenblum closing, Giant made another public offering of common stock in August 1972. Touche furnished for this Giant registration statement the audited financial statements for each of the five fiscal years ending January 29, 1972, to which was affixed Touche's unqualified opinion.

Giant had manipulated its books by falsely recording assets that it did not own and omitting substantial amounts of accounts payable so that the financial information that Touche had certified in the 1971 and 1972 statements was incorrect. (The SEC found that Touche's audit for the 1972 statements did not meet the requirements of the accounting profession. The SEC entered a consent order of censure against Touche.) The fraud was uncovered in the early months of 1973. Trading in Giant stock on the American Stock Exchange was suspended in April 1973 and never resumed. On May 22, 1973, Touche withdrew its audit for the year ending January 29, 1972. Giant filed a bankruptcy petition in September 1973. The Giant stock received by the plaintiffs in the merger had become worthless.

The plaintiffs' complaint, predicated on the audited financials for the years ending January 30, 1971 and January 29, 1972, charged fraudulent misrepresentation, gross negligence, negligence and breach of warranty. Touche moved for partial summary judgment. It sought to have the court dismiss the claims. The trial court granted the motion with respect to the 1971 financials and denied it as to the 1972 financials. . . . Thus the propriety of the trial court's disposition of Touche's entire motion for partial summary judgment is now before us.

II.

An independent auditor is engaged to review and examine a company's financial statements and then to issue an opinion with respect to the fairness of that presentation. That report is customarily attached to the financial statements and then distributed by the company for various purposes. Recipients may be stockholders, potential investors, creditors and potential creditors. When these parties rely upon a negligently prepared auditor's report and suffer damages as a result, the question arises whether they may look to the auditor for compensation. In other words, to whom does the auditor owe a duty? The traditional rule is that the auditor's duty is owed only to those with whom he is in privity or to those who are known beneficiaries at the time of the auditor's undertaking. This rule is commonly attributed to an opinion of Chief Judge Cardozo in *Ultramares v. Touche* (1931). A second rule has been expressed in Section 552 of the *Restatement (Second) of Torts*. Under the *Restatement*, liability is extended to a known and intended class of beneficiaries. For example, if the auditor knows that the report is to be prepared for bank borrowing, then his duty would run to the bank to whom the company delivered the opinion. A third rule is that the auditor's duty is owed to those whom the auditor should reasonably foresee as recipients from the company of the financial statements for authorized business purposes.

A claim against the auditor is one predicated upon his representations. In the complaint the plaintiffs seek recompense for economic loss from a negligent supplier of a service with whom the claimants are not in privity. It has generally been held with respect to accountants that imposition of liability requires a privity or privity-like relationship between the claimant and the negligent actor. We must examine a number of issues in order to determine whether we should so limit such actions in New Jersey.

We shall determine what duty the auditor should bear to best serve the public interest in light of the role of the auditor in today's economy.

III.

An incorrect statement, negligently made and justifiably relied upon, may be the basis for recovery of damages for economic loss or injury sustained as a consequence of that reliance.

Our case law, however, has been split on whether privity or a similar relationship is necessary in a suit against the supplier of a service for negligent misrepresentation causing economic loss. . . .

We have never passed upon the problem of an accountant's liability to third persons who have relied on negligently audited statements to their economic detriment. Many other jurisdictions have limited an accountant's liability to those with whom the accountant is in privity. The leading opinion is that of Chief Judge Cardozo in *Ultramares v. Touche* (1931). In rejecting a claim against an accounting firm for a negligent audit relied upon by a third person who advanced credit to the firm's client, he wrote:

> If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.

Chief Judge Cardozo . . . believed that imposition of this type of exposure would be an undue burden upon the declarants, when balanced against the functions they performed. . . . *Ultramares* acknowledges the existence of a duty only in favor of the person for whose "primary benefit" the statements were intended.

Many commentators have questioned the wisdom of *Ultramares.* Criticism of the primary benefit rule led in part to the adoption of Section 552 of the *Restatement (Second) of Torts*, which limited liability for negligent misrepresentation to the loss:

> suffered (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and (b) through reliance upon it in a transaction that

> he [the auditor] intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

When applied to an auditor, the *Restatement* limits the persons to whom he owes a duty to his client, to intended identifiable beneficiaries and to any unidentified member of the intended class of beneficiaries. The only extension in the *Restatement* beyond *Ultramares* appears to be that the auditor need not know the identity of the beneficiaries if they belong to an identifiable group for whom the information was intended to be furnished. There is a substantial split of authority among the courts, some following *Ultramares* and others adopting the *Restatement.*

Both *Ultramares* and the *Restatement* demand a relationship between the relying third party and the auditor. Unless some policy considerations warrant otherwise, privity should not be, and is not, a salutary predicate to prevent recovery. Generally, within the outer limits fixed by the court as a matter of law, the reasonably foreseeable consequences of the negligent act define the duty and should be actionable.

We long ago discarded the requirement of privity in a products liability case based on . . . Judge Cardozo's seminal opinion in *MacPherson v. Buick Motor Co.* (1916). . . . It is clear that an action for negligence with respect to an injury arising out of a defective product may be maintained without privity. . . . Why should a claim of negligent misrepresentation be barred in the absence of privity when no such limit is imposed where the plaintiff's claim is based on liability for defects in products arising out of a negligent misrepresentation? . . . The fundamental issue is whether there should be any duty to respond in damages for economic loss owed to a foreseeable user neither in privity with the declarant nor intended by the declarant to be the user of the statement or opinion.

IV.

There remains to be considered whether the public interest will be served by a proposition holding an auditor responsible for negligence to those persons who the auditor should reasonably foresee will be given the audit to rely upon and do in fact place such reliance on the audit to their detriment. Should there be such a duty imposed? . . .

The fairness of the imposition of a duty on accountants cannot be appraised without an understanding of the independent accountant's auditing function. It is particularly important to be aware of the independent auditor's role in order to assess the propriety of imposing any duty to those who may rely on the audit. . . .

The company prepares the financial statements in the first instance. The independent auditor's role in the accountability process is to scrutinize management's accountability reports. The auditor must make such an examination so as to enable him to express an opinion on the fairness of the financial presentation in the statements. The professional standards of the American Institute of Certified Public Accountants (AICPA) express the auditor's function as follows:

> The objective of the ordinary examination of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles.

The auditor is concerned with generally accepted accounting principles, that is, acceptable assumptions, procedures and techniques for the preparation of financial statements. Auditing standards have been developed by the AICPA governing examination of statements and reporting as to whether generally accepted principles and practices have been followed.

To perform these functions the auditor must, among other things, familiarize himself with the business, its operation and reporting methods and industry-wide conditions. It is necessary to understand the financial and accounting characteristics and practices of the enterprise. In short, the auditor must be so knowledgeable that he can render an "informed opinion."

There are certain limitations within the accounting framework. . . . An auditor's review is subject to similar constraints because the financial statements cannot be more reliable than the underlying accounting methodology. The auditor must critically evaluate the accounting principles selected to measure performance, but some of the basic data upon which the auditor relies are not as a practical matter verifiable. The auditor is neither required to investigate every supporting document, nor deemed to have the training or skills of a lawyer or criminal investigator.

Nonetheless, the independent auditor should be expected to detect illegal or improper acts that would be uncovered in the exercise of normal professional skill and care. The auditor should exercise reasonable care in verifying the underlying data and examining the methodology employed in preparing the financial statements. The accountant must determine whether there are suspicious circumstances and, even in the absence of suspicious circumstances, make a

reasonable sampling or apply some testing technique. This does not mean the auditor will always be able to discover material fraud. Yet the audit, particularly when it uncovers fraud, dishonesty, or some other illegal act, serves an undeniably beneficial public purpose.

At one time the audit was made primarily to inform management of irregularities and inefficiencies in the business. That function remains one of the principal reasons for the audit. Gradually a need for independent audits was generated by public ownership of business enterprises and by requirements of the stock exchanges and the Securities and Exchange Commission (SEC). Institutional investors, investment specialists, stockholders, and lenders demanded more and reliable information. It is now well recognized that the audited statements are made for the use of third parties who have no contractual relationship with the auditor. Moreover, it is common knowledge that companies use audits for many proper business purposes, such as submission to banks and other lending institutions that might advance funds and to suppliers of services and goods that might advance credit. The SEC twenty-five years ago stated: "The responsibility of a public accountant is not only to the client who pays his fee, but also to investors, creditors and others who may rely on the financial statements which he certifies." . . .

The auditor's function has expanded from that of a watchdog for management to an independent evaluator of the adequacy and fairness of financial statements issued by management to stockholders, creditors, and others. . . .

The two most important qualities of the auditor are the expertise that he brings to the project and the independence with which he performs his task. The auditor is not only labeled as independent, but also is expected to be independent in fact. The public accountant must report fairly on the facts whether favorable or unfavorable to the client. It is generally in management's interest that the financial statements reflect performance in the most favorable light. There is an inherent divergence of interests between management and third persons who will rely upon these statements. Without the auditor's oversight, management might be tempted to tilt certain items in its favor or to commit outright misrepresentation. . . .

The objection to imposing a duty on accountants to third persons to whom the statements have been given by the company for proper business purposes is the spectre of financial catastrophe. It is feared that the unknown costs will be so severe that accounting firms will not be able to absorb the losses that will be visited upon them, particularly because in all likelihood the audited clients will be judgment proof or unable to satisfy their share of the indebtedness due. The reasonableness of this concern is questionable.

Many who would benefit from the rule that an auditor owes a duty of reasonable care to those to whom the company may foreseeably deliver the audit are now protected. Accounting firms are presently liable to purchasers of securities in public offerings when they have misstated a material fact in the financial statements. It is interesting to compare the elements constituting liability under the Securities Act of 1933 with the traditional negligence (non-privity) standard. Accountants' liability under Section 11 is often available where an action for ordinary negligence would not succeed. Under section 11 the plaintiff need not prove scienter, negligence, or proximate cause; the burden of proof is on the accountants to establish freedom from negligence or "due diligence." *Escott v. Bar Chris Construction Corp.*, 283 *F.Supp.* 643 (1968). Even under the rule of *Ultramares* accounting firms are liable, irrespective of privity, to all third persons for fraud and gross negligence that raises an inference of fraud. . . .

Independent auditors have apparently been able to obtain liability insurance covering these risks or otherwise to satisfy their financial obligations. We have no reason to believe that they may not purchase malpractice insurance policies that cover their negligent acts leading to misstatements relied upon by persons who receive the audit from the company pursuant to a proper business purpose. . . .

The imposition of a duty to foreseeable users may cause accounting firms to engage in more thorough reviews. This might entail setting up stricter standards and applying closer supervision, which should tend to reduce the number of instances in which liability would ensue. Much of the costs incurred either because of more thorough auditing review or increased insurance premiums would be borne by the business entity and its stockholders or its customers.

The extent of financial exposure has limits. The plaintiffs would have to establish that they received the audited statements from the company pursuant to a proper company purpose, that they, in accordance with that purpose, relied on the statements and that the misstatements therein were due to the auditor's negligence and were a proximate cause of the plaintiff's damage. The injured party would be limited to recovery of actual losses due to reliance on the misstatement. The accounting firm could seek indemnification or contribution from the company and those blameworthy officers or employees. The auditors could in some circumstances, such as when auditing a privately owned company, expressly limit in their certificates the persons or class of persons who would be entitled to rely upon

the audit. . . . . In the final analysis the injured party should recover damages due to an independent auditor's negligence. This would shift the loss from the innocent creditor or investor to the one responsible for the loss. Accountants will be encouraged to exercise greater care leading to greater diligence in conducting audits. . . .

When the independent auditor furnishes an opinion with no limitation in the certificate as to whom the company may disseminate the financial statements, he has a duty to all those whom that auditor should reasonably foresee as recipients from the company of the statements for its proper business purposes, provided that the recipients rely on the statements pursuant to those business purposes. The principle that we have adopted applies by its terms only to those foreseeable users who receive the audited statements from the business entity for a proper business purpose to influence a business decision of the user, the audit having been made for that business entity. Thus, an institutional investor or portfolio manager who does not obtain audited statements from the company would not come within the stated principle. . . .

Certified financial statements have become the benchmark for various reasonably foreseeable business purposes and accountants have been engaged to satisfy those ends. In those circumstances accounting firms should no longer be permitted to hide within the citadel of privity and avoid liability for their malpractice. The public interest will be served by the rule we promulgate this day.

V.

Both the trial court and the Appellate Division ruled that the plaintiffs' claim based on negligent preparation of the 1971 audit could not be sustained because the accountants were not aware at the time the audit was prepared of the existence of the plaintiffs or of a limited class of which the plaintiffs were members. The defendant's audit had been completed on April 16, 1971 and Giant's merger discussions with the plaintiff did not begin until the following September. Therefore the defendants had no knowledge of the Rosenblums or the prospective merger at the time of the preparation of the audit and there could be no liability under *Ultramares* or the *Restatement*. . . .

When the defendants prepared the Giant audit, they knew or should have known that Giant would probably use the audited figures for many proper business purposes. They knew that it was to be incorporated in Giant's annual report, and would be filed with the SEC in conjunction with Giant's proxy solicitation material for its annual stockholder meeting. The defendants also knew that the audited financial statements would be available and useful for other proper business purposes, such as public offerings of securities, credit, and corporate acquisitions. These were clearly foreseeable potential uses of the audited financials at the time of their preparation.

Defendants became aware of plaintiffs' existence and their intended use of these statements before the plaintiffs relied on the accuracy of these financials. The defendants knew that the merger agreement included a representation that the prospectus used for the public offering in December 1971 contained no untrue statement of a material fact and did not omit to state any material fact. The defendants knew that this prospectus included their opinion that the financials had been prepared in accordance with generally accepted accounting principles and fairly presented Giant's financial condition. . . . Defendants' ignorance of the precise use to which the statements would be put does not eliminate their obligation. We find that it is necessary only that Giant, the entity for whom the audit was being made, used it for a proper business purpose. There was no limitation in the accountants' opinion. They could reasonably expect that their client would distribute the statements in furtherance of matters relating to its business. Having inserted the audit in that economic stream, the defendants should be responsible for their careless misrepresentations to parties who justifiably relied upon their expert opinions. . . .

The cause is remanded to the trial court for further proceedings consistent with this opinion.

Cast Art Industries, LLLC, Plaintiff-Respondent v. KPMG LLLP, Defendant-Appellant

Supreme Court of New Jersey

209 N.J. 208; 36 A.3d 1049

February 16, 2012, Decided

JUDGES: CHIEF JUSTICE RABNER and JUSTICES LONG, LaVECCHIA, and HOENS join in JUDGE WEFING's opinion. JUSTICES ALBIN and PATTERSON did not participate.

Following a lengthy trial in this accounting malpractice action, a jury returned a verdict in plaintiffs' favor and awarded damages totaling $31.8 million. Following post-trial motions and computation of pre-judgment interest, the trial court entered an amended final judgment against defendant for $38,096,902. Defendant appealed from that judgment. The Appellate Division upheld the verdict on liability but vacated the damage award and remanded for a new trial on damages. . . . After reviewing the extensive record and considering the arguments advanced, we have concluded that the verdict in favor of plaintiffs cannot stand, and we reverse the judgment of the Appellate Division.

I.

Plaintiffs commenced this litigation seeking damages for the losses they said they incurred following the bankruptcy and subsequent liquidation of Cast Art Industries (Cast Art). The business of Cast Art was the production and sale of collectible figurines and giftware. . . . Papel Giftware (Papel), located in New Jersey, was in the same line of business as Cast Art, and in the spring of 2000 Cast Art became interested in acquiring Papel. Among the factors that made such an acquisition attractive to Cast Art were Papel's large number of existing customer accounts, its existing sales force, and its production facilities. Cast Art retained the services of attorneys (Latham & Watkins), investment bankers (Friedman Billings & Ramsey), and accountants (Moss Adams) to advise it in connection with this proposed transaction. Eventually, it decided that a merger, rather than an acquisition, would be the preferable format for such a transaction. Cast Art lacked the financial ability to complete such a transaction on its own. As a result, it negotiated a loan agreement with PNC Bank (PNC) for $22 million to fund the venture. One of PNC's conditions to advancing the $22 million loan, however, was that it receive audited financial statements of Papel. . . .

Defendant KPMG had audited Papel's financial statements since 1997, when Papel's principal, Joel Kier, had acquired it from a prior owner. KPMG was already in the process of auditing Papel's 1998 and 1999 financial statements when Cast Art and Papel began their merger discussions. In its letter to the chairman of Papel's audit committee, dated November 17, 1999, in which it agreed to undertake these audits and report the results, KPMG noted the parameters of its work:

> An audit is planned and performed to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Therefore, there is a risk that material errors, fraud (including fraud that may be an illegal act), and other illegal acts may exist and not be detected by an audit performed in accordance with generally accepted auditing standards. Also, an audit is not designed to detect matters that are immaterial to the financial statements.

The process of KPMG completing its audits of Papel's financial statements for the years 1998 and 1999 was protracted; KPMG attributed this delay in part to difficulties it encountered in obtaining the necessary records from Papel. In addition, tensions developed between John Quinn, the KPMG partner responsible for the audit, and Frederick Wasserman, Papel's chief financial officer, when Wasserman resisted certain adjustments that KPMG concluded had to be made to Papel's financial statements. Eventually, Wasserman agreed to certain of the adjustments, and KPMG concluded that the remainder were immaterial, and thus it waived their inclusion. In September 2000, KPMG delivered to Papel the completed audits for the years 1998 and 1999. KPMG included the following statement in its accompanying opinion letter, which again was addressed to the chairman of Papel's audit committee:

> We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

KPMG concluded its opinion letter to Papel with the observation that as of December 31, 1999, Papel "was not in compliance with certain financial covenants" with its lenders, which KPMG characterized as raising "substantial doubt about the Company's ability to continue as a going concern."

Cast Art obtained copies of the completed 1998 and 1999 audits and provided copies to PNC in satisfaction of its obligation under the loan agreement. Three months later, in December 2000, Cast Art and Papel consummated the merger. Shortly after the merger was finalized, Cast Art began to experience difficulty in collecting some of the accounts receivable that it had believed Papel had had outstanding prior to the merger. Cast Art began its own investigation and learned that the 1998 and 1999 financial statements prepared by Papel were inaccurate and that Papel evidently had engaged regularly in the practice of accelerating revenue.

Papel's financial statements had noted that Papel's stated policy was to recognize revenue from sales when goods were shipped and invoices sent. Papel did not comply with that policy, however, and would routinely book revenue from goods that had not yet been shipped. For example, testimony at trial established that Papel would pack goods for shipment and book the revenue but then simply place the shipping cartons in trailers on its property and color code the invoices to note when the goods were, in fact, to be shipped and billed. There was also testimony that at certain points Papel would not close out its books at month's end. Rather, it would hold them open and book in the improperly extended month revenue that was earned in the following period. There was also testimony that at least one transaction, referred to at trial as the "Bookman" transaction, was a fraudulent entry of a $121,244 sale that never occurred.

Although Cast Art knew at the time of the merger that Papel was carrying a significant amount of debt, it was unaware of those accounting irregularities until after the merger was complete. The surviving corporation was unable to generate sufficient revenue to carry its debt load and produce new goods, and it eventually failed.

II.

In this litigation, Cast Art alleged that KPMG negligently audited Papel because its audit had not revealed Papel's accounting irregularities and sought to recover for the loss of its business. It contended that if KPMG had performed a proper audit, it would have uncovered the fraudulent accounting activity that was taking place at Papel. Cast Art further maintained that it never would have proceeded with the merger if it had been alerted to this fraud. Thus, Cast Art asserted that its losses were caused by KPMG's negligence and that KPMG should be responsible to make it whole.

KPMG defended this litigation on several fronts. It argued that because Cast Art had not retained it to audit Papel, Cast Art was not its client, and Cast Art's claim was consequently barred by the [New Jersey] Accountant Liability Act, *N.J.S.A.* 2A:53A-25. Prior to trial, KPMG unsuccessfully sought summary judgment on that basis. At trial KPMG denied any negligence on its part and stressed that Cast Art had received advice cautioning it not to proceed with the merger in light of Papel's poor financial condition. KPMG also maintained that Cast Art's failure was attributable to factors that were wholly unrelated to the actions of KPMG. It pointed, for instance, to a decrease in sales that Cast Art had experienced before the merger and also contended there was a general downturn in the collectibles market.

As we noted earlier, Cast Art prevailed in the trial court. On appeal, KPMG . . . argued that Cast Art had failed to establish negligence in the manner in which KPMG had audited Papel's financial statements and that the trial court had erred in its charge to the jury with respect to the question of negligence. It also contended that Cast Art had failed to prove a sufficient causal link between the actions of KPMG and the losses Cast Art incurred.

The Appellate Division rejected KPMG's arguments.

A.

KPMG presents a number of arguments in support of its position in this Court. It contends that the construction placed on [the Accountant Liability Act] by the trial court and the Appellate Division was incorrect and had the effect of reinstating foreseeability as the test to determine the scope of accountant liability to third parties. KPMG asserts that under the proper construction of the Accountant Liability Act, it could not be held liable to Cast Art because KPMG did not know at the time it agreed to perform these audits that Papel and Cast Art were contemplating a merger and that Cast Art would be relying on its auditing work. . . . Along this vein, it contends that the Appellate Division erroneously concluded that mere knowledge by KPMG that Cast Art needed the audit reports to complete the merger transaction equaled an agreement by KPMG that it owed an independent duty to Cast Art, apart from its duty to Papel. . . .

KPMG also contends that Cast Art failed to demonstrate how deficiencies that might have existed in its audit reports proximately caused the collapse of Cast Art.

B.

Cast Art, on the other hand, rejects KPMG's construction of *N.J.S.A.* 2A:53A-25 [the Accountant Liability Act]. It contends that an accountant may be held liable to a third party if the accountant, at any time prior to the completion of its work, knows that its work will be made available to, and will be relied on by, that nonclient third party. In addition, Cast Art points to testimony with respect to a conference call involving Cast Art and KPMG to support its position that KPMG knew the significance its audit reports held for Cast Art. . . .

C.

Two “amici” [third parties who submit briefs to the court in support of one of the litigating parties], New Jersey Society of Certified Public Accountants and American Institute of Certified Public Accountants, participated in the appeal before the Appellate Division and before this Court. Both amici contend that the Appellate Division's construction of *N.J.S.A.* 2A:53A-25 was incorrect and contrary to the intent of the Legislature when it adopted this statute. . . .

III.

We do not find it necessary to address all of the contentions put forth by the parties and the amici. In our judgment, the dispositive issue is the proper construction of the Accountant Liability Act, *N.J.S.A.* 2A:53A-25.

The arguments put forth by the parties with respect to the proper construction of *N.J.S.A.* 2A:53A-25 are best understood and analyzed if there is an appreciation of the historical development of the manner in which courts have addressed the issue of an auditor's potential liability to nonclient third parties. Such an appreciation, in turn, requires an understanding of the fundamental nature and purpose of an audit.

> An audit is a systematic, objective examination of a company's financial statements. . . . The purpose of an audit is to determine if the statements fairly present the financial condition of the company . . . .
>
> After concluding the audit, the auditor issues its report [which] expresses the auditor's independent, professional opinion about the fairness of the financial statements. . . .

Because an auditor's report may be circulated well beyond the borders of its subject, case law has developed three analytical frameworks within which to consider whether and under what circumstances auditors may be held liable for their negligence in conducting an audit. The earliest cases dealing with the question of an auditor's liability to third parties for negligence required the existence of privity or its equivalence as a necessary precondition to holding an auditor liable.

The leading case standing for that principle is *Ultramares v. Touche*, 255 N.Y. 170 (1931). The defendant in that case had for several years audited the financial statements of a rubber dealer, Fred Stern & Co. (Stern). In accordance with its past practice, the defendant audited Stern's records for the year 1923 and at the completion certified that the balance sheet it had prepared from Stern's records "present[ed] a true and correct view" of the company's financial condition. The plaintiff, a factor, relied on the defendant's audit and advanced significant funds to the company. Unbeknownst to the defendant auditor, employees of Stern had entered false transactions into the company's records, and in fact Stern was insolvent when the defendant had reported a net worth in excess of $1 million. The plaintiff factor [Ultramares] sued the defendant auditor to recover its losses. The New York Court of Appeals held the auditor did not owe a duty of care to the factor, and thus the factor could not sue the auditor for negligence. To impose liability for negligence on an auditor in the absence of privity or an equivalent relationship, wrote Justice Cardozo, "may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."

New York, in essence, retains this test although it no longer insists on contractual privity; rather, it requires "some conduct on the part of the accountants linking them" to the parties claiming a loss. *Credit Alliance Corp. v. Arthur Andersen & Co.*, 65 N.Y.2d 536 (N.Y. 1985).

The Restatement (Second) of Torts formulated a somewhat broader test.

> One who, in the course of his business, profession or employment . . . supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.
> *Restatement (Second) of Torts* § 552(1) (1977).

To forestall the "indeterminate" liability forecast by the *Ultramares* court, subsection (2) of § 552 limits the scope of this potential liability "to those persons, or classes of persons, whom [the accountant] knows and intends will rely on his opinion, or whom he knows his client intends will so rely."

New Jersey rejected those tests in *Rosenblum v. Adler*, 93 N.J. 324 (1983). In that case, the plaintiffs owned and operated two businesses that they sold to Giant Stores Corporation (Giant) and as part of that sale, plaintiffs received stock in Giant. The defendants were partners in Touche Ross & Co., the accounting firm that had audited Giant's financial statements during the relevant time period. The firm had not, however, been directly involved in the negotiations between the plaintiffs and Giant. The Giant stock the plaintiffs received subsequently turned out to be worthless when it was learned that the financial statements prepared by Giant and audited by Touche were false. The plaintiffs sued for their losses, alleging Touche had been negligent in its audit of Giant's books. The defendants responded they could not be held responsible to the plaintiffs, with whom they had had no contractual relationship. The Court rejected that contention with the following statement:

> When the independent auditor furnishes an opinion with no limitation in the certificate as to whom the company may disseminate the financial statements, he has a duty to all those whom that auditor should reasonably foresee as recipients from the company of the statements for its proper business purposes, provided that the recipients rely on the statements pursuant to those business purposes. . . . In those circumstances accounting firms should no longer be permitted to hide within the citadel of privity and avoid liability for their malpractice.

Only a few states adopted this expansive foreseeability test, and New Jersey has, through the passage of *N.J.S.A.* 2A:53A-25 in 1995, since abandoned it.

The New Jersey statute established preconditions to the imposition of liability on an accountant to a nonclient third party. These preconditions are that the accountant

> (a) knew at the time of the engagement by the client, or agreed with the client after the time of the engagement, that the professional accounting service rendered to the client would be made available to the claimant, who was specifically identified to the accountant in connection with a specified transaction made by the claimant;
>
> (b) knew that the claimant intended to rely upon the professional accounting service in connection with the specified transaction; and
>
> (c) directly expressed to the claimant, by words or conduct, the accountant's understanding of the claimant's intended reliance on the professional accounting service. [*N.J.S.A.* 2A:53A-25(b)(2).]

Clearly, KPMG did not know in November 1999, when it agreed to perform this audit, that its work could play a role in a subsequent merger because its agreement predated by several months Cast Art's interest in Papel. Cast Art urges that the statute should not be given such a restrictive interpretation and that the phrase "at the time of the engagement" should be construed to mean "at any time during the period of the engagement." KPMG, on the other hand, contends the phrase means "at the outset of the engagement." . . .

In our judgment, a construction of the statute that interprets the phrase "at the time of the engagement" to mean "at the outset of the engagement" is more consonant with the overall intent of the Legislature to narrow the circumstances under which an accountant may be liable to a third party than a construction that interprets the phrase to mean "any time during the engagement." . . . Our conclusion with respect to the proper construction of the Accountant Liability Act is fortified by the nature of an engagement letter, for an auditor's "liability must be defined by the scope of the engagement it entered." An auditor is entitled to know at the outset the scope of the work it is being requested to perform and the concomitant risk it is being asked to assume. We have earlier set forth the pertinent language of KPMG's engagement letter with Papel with respect to those audits, and it is silent as to Cast Art. Thus, at the outset of its engagement with Papel, KPMG was not told that a nonclient would be relying on its work. . . .

Because Cast Art failed to establish that KPMG "knew at the time of the engagement by the client" or thereafter agreed that Cast Art could rely on its work in proceeding with this merger, Cast Art failed to satisfy the requisite elements of *N.J.S.A.* 2A:53A-25(b)(2), and KPMG was entitled to judgment. We thus reverse the contrary judgment of the Appellate Division. In light of this conclusion, the remaining issues raised by the parties in conjunction with this appeal are moot and need not be addressed.

IV.

The judgment of the Appellate Division is reversed, and the matter is remanded to the trial court for entry of a judgment of dismissal.

Gerald L. Herzfeld, Plaintiff-Appellee, v. Laventhol, Krekstein, Horwath & Horwath, Defendant-Appellant.

United States Court of Appeals for the Second Circuit

540 F.2d 27 (1976)

JUDGES: Moore and Timbers, Circuit Judges and Coffrin District Judge.

OPINION BY: MOORE, Circuit Judge:

Laventhol, Krekstein, Horwath & Horwath, a firm of certified public accountants ("Laventhol"), appeals from an amended judgment for the amount of $153,000, entered against it and in favor of plaintiff, Gerald L. Herzfeld ("Herzfeld") after a trial to the Court. . . . We affirm the Herzfeld award. . . .

Originally, Herzfeld had sued Laventhol and 11 other defendants to recover $510,000 which he claimed that he had paid for certain securities of Firestone Group, Ltd. ("FGL"). The substance of Herzfeld's charges was that the representations made to him by the defendants in connection with the purchase were materially misleading and that there were omissions of material facts, all of which were inducing factors, and on which he relied, in making his purchase and in not exercising his right of rescission. Herzfeld predicated his suit upon alleged violations of the securities laws of the United States, the New York General Business Law, and common law fraud. . . .

That suit was settled by all defendants except Laventhol for $357,000. Thereafter, by an amended complaint, Herzfeld sought to recoup the balance ($153,000) of the $510,000 from Laventhol. . . .

The specific facts are particularly important in determining the rights of the parties [Herzfeld and Laventhol] are best developed in chronological order.

FGL was engaged in the business of purchasing real estate and thereafter syndicating or reselling it. In November 1969, FGL planned to raise $7,500,000 by the private placement through Allen and Company, Incorporated. . . .

Through friends, Herzfeld became interested in the venture. A purchase agreement, dated November 10, 1969, was delivered to Herzfeld by FGL with an accompanying letter which advised him that the closing date for the sale of the notes would be December 16, 1969, "to permit the preparation of audited financial statements, as at and for the eleven months ended November 30, 1969, copies of which will be delivered to you." The letter added that these "audited statements will serve as the basis for confirming the unaudited Projected Financial Statements annexed to the Stock Purchase Agreement as Exhibit B." Exhibit B was a balance sheet and income statement. It portrayed FGL as a strikingly profitable corporation with over $20 million in assets, a net worth of close to a million dollars, sales of over $17 million, deferred income of $2.7 million and an after-tax income of $315,000. FGL warranted that it fairly presented its financial condition as at November 30, 1969.

Herzfeld read the entire income statement and the balance sheet and noted that it represented FGL as being very profitable. . . . He then signed the agreement to purchase two units thereunder.

To prepare the promised audit, FGL retained Laventhol as the accountants for the task. The Herzfeld-Laventhol lawsuit and this appeal therefrom involve only the deeds and alleged misdeeds of Laventhol in making its audit which was submitted to FGL and thereafter to the security purchasers, including Herzfeld. . . . .

The spotlight of Herzfeld's claim of a materially misleading audit, knowingly made with admitted awareness of the facts, focuses upon Laventhol's accounting treatment of two real estate transactions in which FGL allegedly engaged in late November 1969, referred to herein as the FGL-Monterey purchase and the FGL-Continental sale. Purporting to reflect these transactions are two agreements. Each agreement is on an identical printed form. The first is dated November 22, 1969 and is between Monterey Nursing Inns, Inc. ("Monterey") as seller and FGL as buyer. . . . Twenty-three (23) nursing homes were the subject of the sale. The purchase price is stated as $13,362,500, $5,000 of which was payable before November 30, 1969 (i.e., upon the signing of the contract).

On an identical printed form with almost identical typewritten inserts is an agreement by FGL as seller to sell to Continental Recreation Company, Ltd. ("Continental") as buyer. . . . The purchase price is stated as $15,393,000 with $25,000 as a down payment.

This purchase and sale of nursing homes, if ever consummated, would have been the largest single transaction in the history of FGL. Placing these two purported agreements side by side, if the obligations therein were ever fulfilled in the future, FGL would have bought Monterey for $13,362,500 and sold it for $15,393,000, thus producing a profit, when, as and if the transactions were consummated, of $2,030,500, no part of which was even contemplated as having been received prior to November 30, 1969, and only payments of $5000 by FGL to Monterey and $25,000 from Continental to FGL may have been made.

A comparison of the financial condition of FGL with and without these transactions demonstrates the importance of them to FGL:

	Monterey Included	Monterey Excluded
Sales	$22,132,607	$6,739,607
Total Current Assets	6,290,987	1,300,737
Net Income	66,000	[169,000]
Deferred Profit	1,795,000	0
Earnings/Share	$0.10	[0.25]

Thus, the accounting treatment of these transactions determined the health of FGL's financial picture. Laventhol knew this was so. By this treatment, namely, immediate recognition of a so-called profit, Laventhol notes . . reveal the conversion of estimated $772,108 losses into a $1,257,892 gain by the addition of the $2,030,500 "profit". . . .

Little wonder that when at the outset a Laventhol partner was discussing the situation from an accounting standpoint, he referred to it as a "fictitious or proposed or artificial transaction." But Laventhol undertook the task, albeit it had to engage in considerable soul-searching during it. Laventhol also learned that Monterey transactions were nowhere recorded in the FGL books and that there were no corporate minutes or resolutions approving or even adverting to the transactions. The absence was remedied by Laventhol, who prepared adjusting entries and ordered the FGL controller to enter them in the FGL books. Illustrative is the letter from Laventhol's audit manager to FGL's controller enclosing "the journal entries which *we generated* for the financial statements at November 30" (emphasis added). These entries were prepared by Laventhol as if the transaction had been consummated: yet the agreements on their face showed that no profits could result therefrom until long after November 30.

Under date of November 30, 1969, appears as a general journal entry an item "Profit on sale $2,030,500" and also a credit of $3,995,000 "to record purchase and sale of various hospitals from Monterey . . ." A further Laventhol paper, dated December 6, 1969, reverses a tax liability entry on the Continental sale which reads that Laventhol "will not record as sale since not enough deposit was given to Firestone."

The contracts came to Laventhol's attention on or about December 1st through its partners, Chazen and Lipkin, and Schwabb, the audit manager. Schwabb sought Lipkin's advice about the proper way to report the transactions in the audit. Lipkin sought to gather the pertinent information by meeting with Scott, a FGL vice-president, and Firestone. Scott told him that FGL was busy acquiring the necessary documentation. Firestone said that the agreements were legitimate and described Continental's principal, Max Ruderian, as an experienced real estate operator and a wealthy individual. Laventhol learned that Continental had a net worth of $100,000 and that its assets consisted of "miniature golf courses plus other assets."

Lipkin also examined the sales contracts. He was an attorney but had only practiced one year. He concluded that the contracts were legally enforcible. He consulted another Laventhol partner who assured him that there need be no concern about Ruderian. Ruderian's references concurred in the appraisal.

The first tangible results of Laventhol's accounting efforts appear in its audit enclosed in its letter to FGL, dated December 6, 1969. In the consolidated balance sheet as of November 30, 1969, the amount of $1,795,500 was recorded "as unrealized gross profit." The same characterization was given to this assumed profit in the income statement with a reference to an explanatory Note 4. This Note only explained the $1,795,500 by stating that "because of the circumstances and nature of the transactions, $1,795,500 of the gross profit thereon will be considered realized when the January 30, 1970 payment is received." The $1,795,500 was apparently arrived at by first adding the $25,000 paid upon execution of the Continental agreement, the $25,000 not yet due (until January 2, 1970) and $185,000 — a liquidated

damage figure for non-performance. These amounts totaled $235,000. They were apparently considered as received and were deducted from the then fictitious profit of $2,030,500, resulting in the figure of $1,795,500. This first December 6, 1969 report is marked "Withdrawn & Superseded."

The reason for the withdrawal is found in the testimony that FGL wanted the audit to reflect the entire amount of $2,030,500 as income resulting from a sale by FGL to Continental. On December 4, 1969, Chazen and Lipkin met with FGL officers. Firestone objected to the tentative accounting treatment of the Monterey transactions, and FGL threatened to withdraw its account and sue Laventhol if the private financing did not go through.

A second report (also dated December 6, 1969) was then submitted by Laventhol. In the income statement "unrealized gross profits (Note 4)" was changed to "Deferred gross profit (Note 4)" and Note 4, itself to read:

> "Of the total gross profit of $2,030,500, $235,000 is included in the Consolidated Income Statement and the balance $1,795,500 will be considered realized when the January 30, 1970 payment is received. The latter amount is included in deferred income in the consolidated balance sheet."

It was this second report which was distributed to the investors, including Herzfeld. Unlike the initial report, the opinion letter accompanying this second and final report was qualified. It stated:

> "In our opinion, subject to collectibility of the balance receivable on the contract of sale (see Note 4 of Notes to Financial Statements) the accompanying consolidated balance sheet and related consolidated statements of income and retained earnings present fairly the financial position of [FGL]. . . ."

Recognizing the difference between the financial statements . . . and the Laventhol audit submitted to Herzfeld and others, on December 16, 1969, FGL attempted to explain by a letter of that date the shift of $1,795,500 from a current to a deferred basis. The financial statements and the qualified opinion letter accompanied the FGL letter which purported to "explain" the distinctions between unaudited projections originally contained in the Agreement and Laventhol's report. No claim is made that Laventhol in any way participated in, or was responsible for, this FGL letter. The FGL letter reads:

> "One transaction which is reflected in the audited financial statements has been treated as producing deferred gross profit rather than current gross profit. While the combination of current and deferred income is actually higher than projected ($1,411,557 as compared with $1,360,000 projected) the shift of $1,795,500 of gross profit on this transaction from a current basis to deferred basis by the auditors has reduced current net income below that originally projected. . . . Deferred income shown on the audited balance sheet has been increased to $2,834,133 as against $1,421,000 projected. . . .
>
> If for any reason you find that the changes reflected in the audited financial statements are of a nature which would have resulted in a change in your investment decision, we will arrange to promptly refund to you your subscription payment. . . .

Herzfeld read this letter outlining the differences, the "Consolidated Statement of Income and Retained Earnings" and noted the deferred gross profit item of $1,795,500. He did not read the Laventhol opinion letter or Note 4. Relying on what he had seen, he was satisfied with his investment and did not take advantage of the rescission offer.

Neither the Monterey nor the Continental transactions were consummated and somewhat over a year later FGL filed a petition under Chapter XI of the Bankruptcy Act. . . leaving a balance of $153,000 unpaid on Herzfeld's original investment, for which . . . he claims that Laventhol, because of its materially misleading audit, is responsible.

The Trial Court first considered Herzfeld's claim under §10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder. . . . The concluded that "the Laventhol report was materially misleading." . . .

The Court held that Laventhol had the necessary *scienter* (the Latin adverb for "knowingly"), namely, "knowledge of the fact that the figures created a false picture . . .", and in addition, that Laventhol "had actual knowledge of the omitted facts which rendered its report misleading." . . .

The Laventhol report . . . was read by Herzfeld. The Court therefore concluded that "The report's false picture of FGL's financial condition was, thus, a substantial, even crucial, factor in convincing Herzfeld that his investment decision to purchase the securities was right," and that Herzfeld had shown sufficient reliance thereon. . . .

The Trial Court invoked the appropriate reliance test. Generally speaking, a plaintiff in a Rule 10b-5 damage action must prove that the misrepresentation was a "substantial factor" in his securities activities. . . . In view of our

imposition of liability on the ground that the Laventhol audit was materially and knowingly misleading and that Herzfeld relied thereon, we need not pass upon the questions whether there was a violation of New York State statutory or common law. . . .

The function of an accountant is not merely to verify the correctness of the addition and subtraction of the company's bookkeepers. Nor does it take a fiscal wizard to appreciate the elemental and universal accounting principle that revenue should not be recognized until the "earning process is complete or virtually complete," and "an exchange has taken place." Insofar as FGL's interest in the Monterey transactions is concerned, the earning process had hardly commenced, let alone neared completion. As of November 30, 1969, FGL had paid only $5,000 cash out of $13.2 million dollar purchase price and accepted a $25,000 "deposit" under a $15.3 million contract. Conditions for closing were unsatisfied. There remained the consummation of its purchase from Monterey. . . . By the close of November 30, 1969, title had not passed. . . .

If the hoped-for profit of $2,030,500 were ever to be realized, it could only come after the transactions had been consummated. . . . FGL's profit till for this transaction as of that date was as bare of profits as Mother Hubbard's cupboard, bare of bones.

An accountant should not represent on an audited statement that income and profit exist unless underlying facts justify that conclusion. Here, the underlying facts known to Laventhol dictated precisely the contrary course, namely, that income should not have been recognized for the accounting period ending November 30, 1969. . . . Laventhol knew that the issuance of FGL securities depended upon a correct ascertainment of that condition. It is undisputed that, without the Monterey-Continental transactions, for the eleven months preceding November 30, FGL had sustained a loss of $772,108. Query: by what accounting legerdemain [deftness or agility] was this figure converted into a substantial profit? . . .

The recognition of Monterey transactions was a materially misleading statement . . . . A reasonable man in Herzfeld's position might well have acted otherwise than to purchase the FGL securities, had the truth been told and the Monterey transactions not been misleadingly represented as a consummated purchase and sale. . . . This misleading impression was aggravated by Laventhol's labelling of the $1,795,500 as "deferred" as opposed to "unrealized" gross profit. Such nomenclature conveyed the erroneous impression that all that profit was so much cash in hand and would be recognized periodically *in futuro* just as if it were prepaid interest or management fees. But as Laventhol well knew, net cash had increased only $20,000, and the transaction was still in doubt. . . .

Having engendered its own quandary, it ill behooves Laventhol to seek the solace of SAP 33, which concerns the rendition of a qualified auditing opinion. But even assuming the propriety of allowing Laventhol to extricate itself by the simple expedient of disclaiming or qualifying its opinion of the very financial statements which it concocted, Laventhol did not follow the route proscribed by SAP 33. . . . . Laventhol did not provide a *clear explanation of the reasons for the qualification*. A simple note would have sufficed saying in substance:

> "Agreements for the purchase of Monterey Nursing Inns, Inc. for $13,362,500 and the sale thereof to Continental Recreation, Inc. for $15,393,000, have been executed. When, as and if these transactions are consummated, FGL expects to realize a profit of $2,030,500."

In sum, we affirm the result reached by the Trial Court in holding that the Laventhol report contained materially misleading omissions and misrepresentations. . . .
The difference between the factual situation before the Supreme Court in *Hochfelder* . . . and the case before us involving affirmative acts by Laventhol which were materially misleading, is clear. The accountants here are not being cast in damages for negligent nonfeasance or misfeasance, but because of their active participation in the preparation and issuance of false and materially misleading accounting reports upon which Herzfeld relied to his damage. . . .

The judgment in favor of Herzfeld against Laventhol in the amount of $153,000 with costs and with interest . . . to the date of payment, is affirmed.

United States v. Arthur Young & Co. et al.

Supreme Court of the United States

465 U.S. 805

March 21, 1984, Decided

CHIEF JUSTICE BURGER delivered the opinion for a unanimous Court.

We granted certiorari to consider whether tax accrual workpapers prepared by a corporation's independent certified public accountant in the course of regular financial audits are protected from disclosure in response to an Internal Revenue Service summons issued under § 7602 of the Internal Revenue Code of 1954 (Code), 26 U. S. C. § 7602.

I A

Respondent Arthur Young & Co. is a firm of certified public accountants. As the independent auditor for respondent Amerada Hess Corp., Young is responsible for reviewing the financial statements prepared by Amerada as required by the federal securities laws. [1] In the course of its review of these financial statements, Young verified Amerada's statement of its contingent tax liabilities, and, in so doing, prepared the tax accrual workpapers at issue in this case. Tax accrual workpapers are documents and memoranda relating to Young's evaluation of Amerada's reserves for contingent tax liabilities. Such workpapers sometimes contain information pertaining to Amerada's financial transactions, identify questionable positions Amerada may have taken on its tax returns, and reflect Young's opinions regarding the validity of such positions. See *infra*, at 810-813.

In 1975 the Internal Revenue Service began a routine audit to determine Amerada's corporate income tax liability for the tax years 1972 through 1974. When the audit revealed that Amerada had made questionable payments of $ 7,830 from a "special disbursement account," the IRS instituted a criminal investigation of Amerada's tax returns as well. In that process, pursuant to Code § 7602, 26 U. S. C. § 7602, [2] the IRS issued an administrative summons to Young, which required Young to make available to the IRS all its Amerada files, including its tax accrual workpapers. Amerada instructed Young not to comply with the summons.

The IRS then commenced this enforcement action against Young in the United States District Court for the Southern District of New York. See 26 U. S. C. § 7604. [3] Amerada intervened, as permitted by 26 U. S. C. § 7609(b)(1). [4] The District Court found that Young's tax accrual workpapers were relevant to the IRS investigation within the meaning of § 7602 and refused to recognize an accountant-client privilege that would protect the workpapers. 496 F.Supp. 1152, 1156-1157 (1980). Accordingly, the District Court ordered the summons enforced.

B

A divided United States Court of Appeals for the Second Circuit affirmed in part and reversed in part. 677 F.2d 211 (1982). The Court of Appeals majority agreed with the District Court that the tax accrual workpapers were relevant to the IRS investigation of Amerada, but held that the public interest in promoting full disclosure to public accountants, and in turn ensuring the integrity of the securities markets, required protection for the work that such independent auditors perform for publicly owned companies. Drawing upon *Hickman* v. *Taylor*, 329 U.S. 495 (1947), and Federal Rule of Civil Procedure 26(b)(3), the Court of Appeals fashioned a work-product immunity doctrine for tax accrual workpapers prepared by independent auditors in the course of compliance with the federal securities laws. Because the IRS had not demonstrated a sufficient showing of need to overcome the immunity and was not seeking to prove fraud on Amerada's part, the Court of Appeals refused to enforce the summons insofar as it sought Young's tax accrual workpapers.

One judge dissented from that portion of the majority opinion creating a work-product immunity for accountants' tax accrual workpapers. The dissent viewed the statutory summons authority, 26 U. S. C. § 7602, as reflecting a congressional decision in favor of the disclosure of such workpapers. The dissent also rejected the policy justifications asserted by the majority for an accountant work-product immunity, reasoning that such protection was not necessary to ensure the integrity of the independent auditor's certification of a corporation's financial statements.

We granted certiorari, 459 U.S. 1199 (1983). We affirm in part and reverse in part.

II

Corporate financial statements are one of the primary sources of information available to guide the decisions of the investing public. In an effort to control the accuracy of the financial data available to investors in the securities markets, various provisions of the federal securities laws require publicly held corporations to file their financial statements with the Securities and Exchange Commission. [5] Commission regulations stipulate that these financial reports must be audited by an independent certified public accountant in accordance with generally accepted auditing standards. [6] By examining the corporation's books and records, the independent auditor determines whether the financial reports of the corporation have been prepared in accordance with generally accepted accounting principles. [7] The auditor then issues an opinion as to whether the financial statements, taken as a whole, fairly present the financial position and operations of the corporation for the relevant period. [8] See n. 13, *infra*.

An important aspect of the auditor's function is to evaluate the adequacy and reasonableness of the corporation's reserve account for contingent tax liabilities. This reserve account, known as the tax accrual account, the noncurrent tax account, or the tax pool, represents the amount set aside by the corporation to cover adjustments and additions to the corporation's actual tax liability. Additional corporate tax liability may arise from a wide variety of transactions. [9] The presence of a reserve account for such contingent tax liabilities reflects the corporation's awareness of, and preparedness for, the possibility of an assessment of additional taxes.

The independent auditor draws upon many sources in evaluating the sufficiency of the corporation's tax accrual account. Initially, the corporation's books, records, and tax returns must be analyzed in light of the relevant Code provisions, Treasury Regulations, Revenue Rulings, and case law. The auditor will also obtain and assess the opinions, speculations, and projections of management with regard to unclear, aggressive, or questionable tax positions that may have been taken on prior tax returns. In exploring the tax consequences of certain transactions, the auditor often engages in a "worst-case" analysis in order to ensure that the tax accrual account accurately reflects the full extent of the corporation's exposure to additional tax liability. From this conglomeration of data, the auditor is able to estimate the potential cost of each particular contingency, as well as the probability that the additional liability may arise.

The auditor's tax accrual workpapers record this process of examination and analysis. Such workpapers may document the auditor's interviews with corporate personnel, judgments on questions of potential tax liability, and suggestions for alternative treatments of certain transactions for tax purposes. Tax accrual workpapers also contain an overall evaluation of the sufficiency of the corporation's reserve for contingent tax liabilities, including an item-by-item analysis of the corporation's potential exposure to additional liability. In short, tax accrual workpapers pinpoint the "soft spots" on a corporation's tax return by highlighting those areas in which the corporate taxpayer has taken a position that may, at some later date, require the payment of additional taxes.

III

In seeking access to Young's tax accrual workpapers, the IRS exercised the summons power conferred by Code § 7602, 26 U. S. C. § 7602, which authorizes the Secretary of the Treasury to summon and "examine any books, papers, records, or other data which may be relevant or material" to a particular tax inquiry. [10] The District Court and the Court of Appeals determined that the tax accrual workpapers at issue in this case satisfied the relevance requirement of § 7602, because they "might have thrown light upon" the correctness of Amerada's tax return. [11] Because the relevance of tax accrual workpapers is a logical predicate to the question whether such workpapers should be protected by some form of work-product immunity, we turn first to an evaluation of the relevance issue. [12] We agree that such workpapers are relevant within the meaning of § 7602.

As the language of § 7602 clearly indicates, an IRS summons is not to be judged by the relevance standards used in deciding whether to admit evidence in federal court. Cf. Fed. Rule Evid. 401. The language "may be" reflects Congress' express intention to allow the IRS to obtain items of even *potential* relevance to an ongoing investigation, without reference to its admissibility. The purpose of Congress is obvious: the Service can hardly be expected to know whether such data will in fact be relevant until they are procured and scrutinized. As a tool of discovery, the § 7602 summons is critical to the investigative and enforcement functions of the IRS, see *United States* v. *Powell*, 379 U.S. 48, 57 (1964); the Service therefore should not be required to establish that the documents it seeks are actually relevant in any technical, evidentiary sense.

That tax accrual workpapers are not actually used in the preparation of tax returns by the taxpayer or its own accountants does not bar a finding of relevance within the meaning of § 7602. The filing of a corporate tax return entails much more than filling in the blanks on an IRS form in accordance with undisputed tax principles; more likely than not, the return is a composite interpretation of corporate transactions made by corporate officers in the light most favorable to the taxpayer. It is the responsibility of the IRS to determine whether the corporate taxpayer in completing its return has stretched a particular tax concept beyond what is allowed. Records that illuminate any aspect of the return -- such as the tax accrual workpapers at issue in this case -- are therefore highly relevant to legitimate IRS inquiry. The Court of Appeals acknowledged this: "It is difficult to say that the assessment by the independent auditor of the correctness of positions taken by the taxpayer in his return would not throw 'light upon' the correctness of the return." 677 F.2d, at 219. We accordingly affirm the Court of Appeals' holding that Young's tax accrual workpapers are relevant to the IRS investigation of Amerada's tax liability.

IV

A

We now turn to consider whether tax accrual workpapers prepared by an independent auditor in the course of a routine review of corporate financial statements should be protected by some form of work-product immunity from disclosure under § 7602. Based upon its evaluation of the competing policies of the federal tax and securities laws, the Court of Appeals found it necessary to create a so-called privilege for the independent auditor's workpapers.

Our complex and comprehensive system of federal taxation, relying as it does upon self-assessment and reporting, demands that all taxpayers be forthright in the disclosure of relevant information to the taxing authorities. Without such disclosure, and the concomitant power of the Government to compel disclosure, our national tax burden would not be fairly and equitably distributed. In order to encourage effective tax investigations, Congress has endowed the IRS with expansive information-gathering authority; § 7602 is the centerpiece of that congressional design. As we noted in *United States* v. *Bisceglia*, 420 U.S. 141, 146 (1975):

"The purpose of [§ 7602] is not to accuse, but to inquire. Although such investigations unquestionably involve some invasion of privacy, they are essential to our self-reporting system, and the alternatives could well involve far less agreeable invasions of house, business, and records."

Similarly, we noted in *United States* v. *Euge*, 444 U.S. 707, 711 (1980):

"[This] Court has consistently construed congressional intent to require that if the summons authority claimed is necessary for the effective performance of congressionally imposed responsibilities to enforce the tax Code, that authority should be upheld absent express statutory prohibition or substantial countervailing policies."

While § 7602 is "subject to the traditional privileges and limitations," *id*., at 714, any other restrictions upon the IRS summons power should be avoided "absent unambiguous directions from Congress." *United States* v. *Bisceglia, supra*, at 150. We are unable to discern the sort of "unambiguous directions from Congress" that would justify a judicially created work-product immunity for tax accrual workpapers summoned under § 7602. Indeed, the very language of § 7602 reflects precisely the opposite: a congressional policy choice *in favor of disclosure* of all information relevant to a legitimate IRS inquiry. In light of this explicit statement by the Legislative Branch, courts should be chary in recognizing exceptions to the broad summons authority of the IRS or in fashioning new privileges that would curtail disclosure under § 7602. Cf. *Milwaukee* v. *Illinois*, 451 U.S. 304, 315 (1981). If the broad latitude granted to the IRS by § 7602 is to be circumscribed, that is a choice for Congress, and not this Court, to make. See *United States* v. *Euge*, 444 U.S., at 712.

B

The Court of Appeals nevertheless concluded that "substantial countervailing policies," *id*., at 711, required the fashioning of a work-product immunity for an independent auditor's tax accrual workpapers. To the extent that the Court of Appeals, in its concern for the "chilling effect" of the disclosure of tax accrual workpapers, sought to facilitate communication between independent auditors and their clients, its remedy more closely resembles a testimonial accountant-client privilege than a work-product immunity for accountants' workpapers. But as this Court stated in *Couch* v. *United States*, 409 U.S. 322, 335 (1973), "no confidential accountant-client privilege exists under federal law, and no state-created privilege has been recognized in federal cases." In light of *Couch*, the Court of Appeals' effort to

foster candid communication between accountant and client by creating a self-styled work-product privilege was misplaced, and conflicts with what we see as the clear intent of Congress.

Nor do we find persuasive the argument that a work-product immunity for accountants' tax accrual workpapers is a fitting analogue to the attorney work-product doctrine established in *Hickman* v. *Taylor*, 329 U.S. 495 (1947). The *Hickman* work-product doctrine was founded upon the private attorney's role as the client's confidential adviser and advocate, a loyal representative whose duty it is to present the client's case in the most favorable possible light. An independent certified public accountant performs a different role. By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. To insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations.

We cannot accept the view that the integrity of the securities markets will suffer absent some protection for accountants' tax accrual workpapers. The Court of Appeals apparently feared that, were the IRS to have access to tax accrual workpapers, a corporation might be tempted to withhold from its auditor certain information relevant and material to a proper evaluation of its financial statements. But the independent certified public accountant cannot be content with the corporation's representations that its tax accrual reserves are adequate; the auditor is ethically and professionally obligated to ascertain for himself as far as possible whether the corporation's contingent tax liabilities have been accurately stated. If the auditor were convinced that the scope of the examination had been limited by management's reluctance to disclose matters relating to the tax accrual reserves, the auditor would be unable to issue an unqualified opinion as to the accuracy of the corporation's financial statements. Instead, the auditor would be required to issue a qualified opinion, an adverse opinion, or a disclaimer of opinion, thereby notifying the investing public of possible potential problems inherent in the corporation's financial reports. [13] Responsible corporate management would not risk a qualified evaluation of a corporate taxpayer's financial posture to afford cover for questionable positions reflected in a prior tax return. [14] Thus, the independent auditor's obligation to serve the public interest assures that the integrity of the securities markets will be preserved, without the need for a work-product immunity for accountants' tax accrual workpapers.

We also reject respondents' position that fundamental fairness precludes IRS access to accountants' tax accrual workpapers. Respondents urge that the enforcement of an IRS summons for accountants' tax accrual workpapers permits the Government to probe the thought processes of its taxpayer citizens, thereby giving the IRS an unfair advantage in negotiating and litigating tax controversies. But if the SEC itself, or a private plaintiff in securities litigation, sought to obtain the tax accrual workpapers at issue in this case, they would surely be entitled to do so. [16] In light of the broad congressional command of § 7602, no sound reason exists for conferring lesser authority upon the IRS than upon a private litigant suing with regard to transactions concerning which the public has no interest.

Congress has granted to the IRS "broad latitude to adopt enforcement techniques helpful in the performance of [its] tax collection and assessment responsibilities." *United States* v. *Euge*, 444 U.S., at 716, n. 9. Recognizing the intrusiveness of demands for the production of tax accrual workpapers, the IRS has demonstrated administrative sensitivity to the concerns expressed by the accounting profession by tightening its internal requirements for the issuance of such summonses. See Internal Revenue Manual § 4024.4 (CCH 1981). [17] Although these IRS guidelines were not applicable during the years at issue in this case, their promulgation further refutes respondents' fairness argument and reflects an administrative flexibility that reinforces our decision not to reduce irrevocably the § 7602 summons power.

V

Beyond question it is desirable and in the public interest to encourage full disclosures by corporate clients to their independent accountants; if it is necessary to balance competing interests, however, the need of the Government for full disclosure of all information relevant to tax liability must also weigh in that balance. This kind of policy choice is best left to the Legislative Branch. Accordingly, the judgment of the Court of Appeals is affirmed in part and reversed in part, and the case is remanded for proceedings consistent with this opinion.

It is so ordered.

IV. Environmental Law

American Trucking Associations, Inc., et al. v. Christine Todd Whitman, Administrator of Environmental Protection Agency, et al.

Supreme Court of the United States

531 U.S. 457; 121 S. Ct. 903

February 27, 2001, Decided

SCALIA, J., delivered the opinion of the Court.

These cases present the following questions: (1) Whether § 109(b)(1) of the Clean Air Act (CAA) delegates legislative power to the Administrator of the Environmental Protection Agency (EPA); (2) Whether the Administrator may consider the costs of implementation in setting national ambient air quality standards (NAAQS) under § 109(b)(1); (3) Whether the Court of Appeals had jurisdiction to review the EPA's interpretation with respect to implementing the revised ozone NAAQS; and (4) If so, whether the EPA's interpretation of that part was permissible.

I

Section 109(a) of the CAA requires the Administrator of the EPA to promulgate NAAQS for each air pollutant for which "air quality criteria" have been issued. Once a NAAQS has been promulgated, the Administrator must review the standard (and the criteria on which it is based) "at five-year intervals" and make "such revisions . . . as may be appropriate." CAA § 109(d)(1), 42 U.S.C. § 7409(d)(1). These cases arose when, on July 18, 1997, the Administrator revised the NAAQS for particulate matter (PM) and ozone. American Trucking Associations, Inc. challenged the new standards in the Court of Appeals for the District of Columbia Circuit.

The District of Columbia Circuit accepted some of the challenges and rejected others. The Administrator and the EPA petitioned this Court for review. We granted certiorari.

II

Section 109(b)(1) instructs the EPA to set primary ambient air quality standards "the attainment and maintenance of which . . . are requisite to protect the public health" with "an adequate margin of safety." Were it not for the hundreds of pages of briefing respondents have submitted on the issue, one would have thought it fairly clear that this text does not permit the EPA to consider costs in setting the standards. . . . The EPA is to identify the maximum airborne concentration of a pollutant that the public health can tolerate, decrease the concentration to provide an "adequate" margin of safety, and set the standard at that level. Nowhere are the costs of achieving such a standard made part of that initial calculation.

Against this most natural of readings, respondents make a lengthy, spirited, but ultimately unsuccessful attack. They begin with the object of § 109(b)(1)'s focus, the "public health."

Respondents argue, many more factors than air pollution affect public health. In particular, the economic cost of implementing a very stringent standard might produce health losses sufficient to offset the health gains achieved in cleaning the air — for example, by closing down whole industries and thereby impoverishing the workers and consumers dependent upon those industries. That is unquestionably true, and Congress was unquestionably aware of it. Thus, Congress had commissioned in the Air Quality Act of 1967 (1967 Act) "a detailed estimate of the cost of carrying out the provisions of this Act; a comprehensive study of the cost of program implementation by affected units of government; and a comprehensive study of the economic impact of air quality standards on the Nation's industries, communities, and other contributing sources of pollution." The 1970 Congress, armed with the results of this study not only anticipated that compliance costs could injure the public health, but provided for that precise exigency. Other provisions explicitly permitted or required economic costs to be taken into account in implementing the air quality standards. Section 111(b)(1)(B), for example, commanded the Administrator to set "standards of performance" for certain new sources of emissions that were to "reflect the degree of emission limitation achievable through the

application of the best system of emission reduction which (taking into account the cost of achieving such reduction) the Administrator determines has been adequately demonstrated." Subsequent amendments to the CAA have added many more provisions directing, in explicit language, that the Administrator consider costs in performing various duties. We have therefore refused to find implicit in ambiguous sections of the CAA an authorization to consider costs that has elsewhere, and so often, been expressly granted. . . .

Even if we were to concede those premises, we still would not conclude that one of the unenumerated factors that the agency can consider in developing and applying the criteria is cost of implementation. That factor is *both* so indirectly related to public health *and* so full of potential for canceling the conclusions drawn from direct health effects that it would surely have been expressly mentioned in §§ 108 and 109 had Congress meant it to be considered. Yet while those provisions describe in detail how the health effects of pollutants in the ambient air are to be calculated and given effect, see § 108(a)(2), they say not a word about costs. . . .

The text of § 109(b), interpreted in its statutory and historical context and with appreciation for its importance to the CAA as a whole, unambiguously bars cost considerations from the NAAQS-setting process, and thus ends the matter for us as well as the EPA. We therefore affirm the judgment of the Court of Appeals on this point.

III

[discussion deleted]

IV

[discussion deleted]

To summarize our holdings in these unusually complex cases: The EPA may not consider implementation costs in setting primary and secondary NAAQS under § 109(b) of the CAA.

The judgment of the Court of Appeals is affirmed in part and reversed in part, and the cases are remanded for proceedings consistent with this opinion.

It is so ordered.

JUSTICE BREYER, concurring in part and concurring in the judgment.

I also agree with the Court's determination that the Clean Air Act does not permit the Environmental Protection Agency to consider the economic costs of implementation when setting national ambient air quality standards under § 109(b)(1) of the Act. . . .

The statute's words, then, authorize the Administrator to consider the severity of a pollutant's potential adverse health effects, the number of those likely to be affected, the distribution of the adverse effects, and the uncertainties surrounding each estimate. They permit the Administrator to take account of comparative health consequences. They allow her to take account of context when determining the acceptability of small risks to health. And they give her considerable discretion when she does so.

This discretion would seem sufficient to avoid the extreme results that some of the industry parties fear. After all, the EPA, in setting standards that "protect the public health" with "an adequate margin of safety," retains discretionary authority to avoid regulating risks that it reasonably concludes are trivial in context. Nor need regulation lead to deindustrialization. Preindustrial society was not a very healthy society; hence a standard demanding the return of the Stone Age would not prove "requisite to protect the public health."

Although I rely more heavily than does the Court upon legislative history and alternative sources of statutory flexibility, I reach the same ultimate conclusion. Section 109 does not delegate to the EPA authority to base the national ambient air quality standards, in whole or in part, upon the economic costs of compliance.

Solid Waste Agency of Northern Cook County v. United States Army Corps of Engineers, et al.

Supreme Court of the United States

531 U.S. 159

October 31, 2000, Argued
January 9, 2001, Decided

JUDGES: REHNQUIST, C. J., delivered the opinion of the Court, in which O'CONNOR, SCALIA, KENNEDY, and THOMAS, JJ., joined. STEVENS, J., filed a dissenting opinion, in which SOUTER, GINSBURG, and BREYER, JJ., joined.

CHIEF JUSTICE REHNQUIST delivered the opinion of the Court.

Section 404(a) of the Clean Water Act (CWA or Act) regulates the discharge of dredged or fill material into "navigable waters." The United States Army Corps of Engineers (Corps), has interpreted § 404(a) to confer federal authority over an abandoned sand and gravel pit in northern Illinois which provides habitat for migratory birds. We are asked to decide whether the provisions of § 404(a) may be fairly extended to these waters, and, if so, whether Congress could exercise such authority consistent with the Commerce Clause, U.S. Const., Art. I, § 8, cl. 3. We answer the first question in the negative and therefore do not reach the second.

Petitioner, the Solid Waste Agency of Northern Cook County (SWANCC), is a consortium of 23 suburban Chicago cities and villages that united in an effort to locate and develop a disposal site for baled nonhazardous solid waste. The Chicago Gravel Company informed the municipalities of the availability of a 533-acre parcel, bestriding the Illinois counties Cook and Kane, which had been the site of a sand and gravel pit mining operation for three decades up until about 1960. Long since abandoned, the old mining site eventually gave way to a successional stage forest, with its remnant excavation trenches evolving into a scattering of permanent and seasonal ponds of varying size (from under one-tenth of an acre to several acres) and depth (from several inches to several feet).

The municipalities decided to purchase the site for disposal of their baled nonhazardous solid waste. By law, SWANCC was required to file for various permits from Cook County and the State of Illinois before it could begin operation of its balefill project. In addition, because the operation called for the filling of some of the permanent and seasonal ponds, SWANCC contacted federal respondents (hereinafter respondents), including the Corps, to determine if a federal landfill permit was required under § 404(a) of the CWA, 33 U.S.C. § 1344(a).

Section 404(a) grants the Corps authority to issue permits "for the discharge of dredged or fill material into the navigable waters at specified disposal sites." The term "navigable waters" is defined under the Act as "the waters of the United States, including the territorial seas." . . . .

In 1986, in an attempt to "clarify" the reach of its jurisdiction, the Corps stated that § 404(a) extends to intrastate waters:

> "a. Which are or would be used as habitat by birds protected by Migratory Bird Treaties; or
>
> "b. Which are or would be used as habitat by other migratory birds which cross state lines; or
>
> "c. Which are or would be used as habitat for endangered species

This last promulgation has been dubbed the "Migratory Bird Rule."

The Corps initially concluded that it had no jurisdiction over the site because it contained no "wetlands," or areas which support "vegetation typically adapted for life in saturated soil conditions." However, after the Illinois Nature Preserves Commission informed the Corps that a number of migratory bird species had been observed at the site, the Corps reconsidered and ultimately asserted jurisdiction over the balefill site pursuant to subpart (b) of the "Migratory Bird Rule." The Corps found that approximately 121 bird species had been observed at the site, including several known to depend upon aquatic environments for a significant portion of their life requirements. Thus, on November 16, 1987, the

Corps formally "determined that the seasonally ponded, abandoned gravel mining depressions located on the project site, while not wetlands, did qualify as 'waters of the United States' . . . based upon the following criteria: (1) the proposed site had been abandoned as a gravel mining operation; (2) the water areas and spoil piles had developed a natural character; and (3) the water areas are used as habitat by migratory bird *[sic]* which cross state lines." U.S. Army Corps of Engineers, Chicago District, Dept. of Army Permit Evaluation and Decision Document, Lodging of Petitioner, Tab No. 1, p. 6.

During the application process, SWANCC made several proposals to mitigate the likely displacement of the migratory birds and to preserve a great blue heron rookery located on the site. Its balefill project ultimately received the necessary local and state approval. By 1993, SWANCC had received a special use planned development permit from the Cook County Board of Appeals, a landfill development permit from the Illinois Environmental Protection Agency, and approval from the Illinois Department of Conservation.

Despite SWANCC's securing the required water quality certification from the Illinois Environmental Protection Agency, the Corps refused to issue a § 404(a) permit. The Corps found that SWANCC had not established that its proposal was the "least environmentally damaging, most practicable alternative" for disposal of nonhazardous solid waste; that SWANCC's failure to set aside sufficient funds to remediate leaks posed an "unacceptable risk to the public's drinking water supply"; and that the impact of the project upon area-sensitive species was "unmitigatable since a landfill surface cannot be redeveloped into a forested habitat."

Petitioner filed suit in the Northern District of Illinois challenging both the Corps' jurisdiction over the site and the merits of its denial of the § 404(a) permit. The District Court granted summary judgment to respondents on the jurisdictional issue, and petitioner abandoned its challenge to the Corps' permit decision. On appeal to the Court of Appeals for the Seventh Circuit, petitioner renewed its attack on respondents' use of the "Migratory Bird Rule" to assert jurisdiction over the site. Petitioner argued that respondents had exceeded their statutory authority in interpreting the CWA to cover nonnavigable, isolated, intrastate waters based upon the presence of migratory birds and, in the alternative, that Congress lacked the power under the Commerce Clause to grant such regulatory jurisdiction.

The Court of Appeals held that the CWA reaches as many waters as the Commerce Clause allows and, given its earlier Commerce Clause ruling, it therefore followed that respondents' "Migratory Bird Rule" was a reasonable interpretation of the Act.

We granted certiorari, 529 U.S. 1129 (2000), and now reverse.

Congress passed the CWA for the stated purpose of "restoring and maintaining the chemical, physical, and biological integrity of the Nation's waters." In so doing, Congress chose to "recognize, preserve, and protect the primary responsibilities and rights of States to prevent, reduce, and eliminate pollution, to plan the development and use (including restoration, preservation, and enhancement) of land and water resources, and to consult with the Administrator in the exercise of his authority under this chapter." Relevant here, § 404(a) authorizes respondents to regulate the discharge of fill material into "navigable waters," . . . which the statute defines as "the waters of the United States, including the territorial seas." Respondents have interpreted these words to cover the abandoned gravel pit at issue here because it is used as habitat for migratory birds. We conclude that the "Migratory Bird Rule" is not fairly supported by the CWA. . . .

Indeed, the Corps' *original* interpretation of the CWA, promulgated two years after its enactment, is inconsistent with that which it espouses here. Its 1974 regulations defined § 404(a)'s "navigable waters" to mean "those waters of the United States which are subject to the ebb and flow of the tide, and/or are presently, or have been in the past, or may be in the future susceptible for use for purposes of interstate or foreign commerce." The Corps emphasized that "it is the water body's capability of use by the public for purposes of transportation or commerce which is the determinative factor." Respondents put forward no persuasive evidence that the Corps mistook Congress' intent in 1974.

Respondents next contend that whatever its original aim in 1972, Congress charted a new course five years later when it approved the more expansive definition of "navigable waters" found in the Corps' 1977 regulations. In July 1977, the Corps formally adopted 33 CFR § 323.2(a)(5) (1978), which defined "waters of the United States" to include "isolated wetlands and lakes, intermittent streams, prairie potholes, and other waters that are not part of a tributary system to interstate waters or to navigable waters of the United States, the degradation or destruction of which could affect interstate commerce." . . .

Where an administrative interpretation of a statute invokes the outer limits of Congress' power, we expect a clear indication that Congress intended that result. This requirement stems from our prudential desire not to needlessly reach constitutional issues and our assumption that Congress does not casually authorize administrative agencies to interpret a statute to push the limit of congressional authority. This concern is heightened where the administrative interpretation alters the federal-state framework by permitting federal encroachment upon a traditional state power. Thus, "where an otherwise acceptable construction of a statute would raise serious constitutional problems, the Court will construe the statute to avoid such problems unless such construction is plainly contrary to the intent of Congress." . . . .

These are significant constitutional questions raised by respondents' application of their regulations, and yet we find nothing approaching a clear statement from Congress that it intended § 404(a) to reach an abandoned sand and gravel pit such as we have here. Permitting respondents to claim federal jurisdiction over ponds and mudflats falling within the "Migratory Bird Rule" would result in a significant impingement of the States' traditional and primary power over land and water use. See, *e.g.*, *Hess* v. *Port Authority Trans-Hudson Corporation,* 513 U.S. 30 (1994) ("Regulation of land use [is] a function traditionally performed by local governments"). Rather than expressing a desire to readjust the federal-state balance in this manner, Congress chose to "recognize, preserve, and protect the primary responsibilities and rights of States . . . to plan the development and use . . . of land and water resources . . . ." We thus read the statute as written to avoid the significant constitutional and federalism questions raised by respondents' interpretation, and therefore reject the request for administrative deference.

We hold that 33 CFR § 328.3(a)(3) (1999), as clarified and applied to petitioner's balefill site pursuant to the "Migratory Bird Rule," exceeds the authority granted to respondents under § 404(a) of the CWA. The judgment of the Court of Appeals for the Seventh Circuit is therefore

Reversed.

DISSENT BY: JUSTICE STEVENS, with whom JUSTICE SOUTER, JUSTICE GINSBURG, and JUSTICE BREYER join, dissenting.

. . . . Today the Court takes an unfortunate step that needlessly weakens our principal safeguard against toxic water.

It is fair to characterize the Clean Water Act as "watershed" legislation. The statute endorsed fundamental changes in both the purpose and the scope of federal regulation of the Nation's waters. In § 13 of the Rivers and Harbors Appropriation Act of 1899 (RHA), Congress had assigned to the Army Corps of Engineers (Corps) the mission of regulating discharges into certain waters in order to protect their use as highways for the transportation of interstate and foreign commerce; the scope of the Corps' jurisdiction under the RHA accordingly extended only to waters that were "navigable." In the CWA, however, Congress broadened the Corps' mission to include the purpose of protecting the quality of our Nation's waters for esthetic, health, recreational, and environmental uses. The scope of its jurisdiction was therefore redefined to encompass all of "the waters of the United States, including the territorial seas." § 1362(7). That definition requires neither actual nor potential navigability.

JAMES E. O'NEIL, Attorney General For the State of Rhode Island, Plaintiff, Appellee, v. WARREN V. PICILLO, SR., ET AL., Defendants, Appellees. AMERICAN CYANAMID COMPANY and ROHM & HAAS COMPANY, Defendants, Appellants

United States Court of Appeals for the First Circuit

883 F.2d 176

(August 21, 1989)

JUDGES: Campbell, Chief Judge, Coffin, Senior Circuit Judge, and Fuste, District Judge.

OPINION BY: COFFIN, Senior Circuit Judge.

In July of 1977, the Picillos agreed to allow part of their pig farm in Coventry, Rhode Island to be used as a disposal site for drummed and bulk waste. That decision proved to be disastrous. Thousands of barrels of hazardous waste were dumped on the farm, culminating later that year in a monstrous fire ripping through the site. In 1979, the state and the Environmental Protection Agency (EPA) jointly undertook to clean up the area. What they found, in the words of the district court, were massive trenches and pits "filled with free-flowing, multi-colored, pungent liquid wastes" and thousands of "dented and corroded drums containing a veritable potpourri of toxic fluids." . . .

This case involves the State of Rhode Island's attempt to recover the clean-up costs it incurred between 1979 and 1982 and to hold responsible parties liable for all future costs associated with the site. The state's complaint originally named thirty-five defendants, all but five of whom eventually entered into settlements totaling $5.8 million, the money to be shared by the state and EPA. After a month-long bench trial, the district court, in a thorough and well reasoned opinion, found three of the remaining five companies jointly and severally liable under section 107 of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA") for all of the State's past clean-up costs not covered by settlement agreements, as well as for all costs that may become necessary in the future. The other two defendants obtained judgments in their favor, the court concluding that the state had failed to prove that the waste attributed to those companies was "hazardous," as that term is defined under the Act.

Two of the three companies held liable at trial, American Cyanamid and Rohm and Haas, have taken this appeal. Both are so called "generators" of waste, as opposed to transporters or site owners. . . . Neither takes issue with the district court's finding that some of their waste made its way to the Picillo site. Rather, they contend that their contribution to the disaster was insubstantial and that it was, therefore, unfair to hold them jointly and severally liable for all of the state's past expenses not covered by settlements. . . . Finally, they argue that the Act should not be applied retroactively. . . . After a careful review of the record, we conclude that none of these arguments suffices to warrant reversal of the judgment below.

. . . . We confine our discussion to appellants' arguments concerning the unfairness of holding them jointly and severally liable for the government's past and future clean-up costs.

Joint and Several Liability: Statutory Background

It is by now well settled that Congress intended that the federal courts develop a uniform approach governing the use of joint and several liability in CERCLA actions. The rule adopted by the majority of courts, and the one we adopt, is based on the Restatement (Second) of Torts: damages should be apportioned only if the defendant can demonstrate that the harm is divisible. . . .

The practical effect of placing the burden on defendants has been that responsible parties rarely escape joint and several liability, courts regularly finding that where wastes of varying (and unknown) degrees of toxicity and migratory potential commingle, it simply is impossible to determine the amount of environmental harm caused by each party. . .

It has not gone unnoticed that holding defendants jointly and severally liable in such situations may often result in defendants paying for more than their share of the harm. . . . Nevertheless, courts have continued to impose joint and several liability on a regular basis, reasoning that where all of the contributing causes cannot fairly be traced, Congress intended for those proven at least partially culpable to bear the cost of the uncertainty. . . .

In enacting the Superfund Amendments and Reauthorization Act of 1986 ("SARA"), Congress had occasion to examine this case law. Rather than add a provision dealing explicitly with joint and several liability, it chose to leave the issue with the courts, to be resolved as it had been — on a case by case basis . . Congress did, however, add two important provisions designed to mitigate the harshness of joint and several liability. First, the 1986 Amendments direct the EPA to offer early settlements to defendants who the Agency believes are responsible for only a small portion of the harm, so-called de minimis settlements. n1 Second, the Amendments provide for a statutory cause of action in Contribution, codifying what most courts had concluded was implicit in the 1980 Act. Under this section, courts "may allocate response costs among liable parties using such equitable factors as the court determines are appropriate." We note that appellants already have initiated a contribution action against seven parties before the same district court judge who heard this case.

While a right of contribution undoubtedly softens the blow where parties cannot prove that the harm is divisible, it is not a complete panacea since it frequently will be difficult for defendants to locate a sufficient number of additional, solvent parties. Moreover, there are significant transaction costs involved in bringing other responsible parties to court. If it were possible to locate all responsible parties and to do so with little cost, the issue of joint and several liability obviously would be of only marginal significance. We, therefore, must examine carefully appellants' claim that they have met their burden of showing that the harm in this case is divisible.

Divisibility

The district court issued two rulings on joint and several liability. First, the court held appellants jointly and severally liable for all of the state's past costs not covered by settlements, roughly $1.4 million including prejudgment interest. According to appellants, this money was spent exclusively on "removal" costs or "surface cleanup" (e.g., sampling the waste, contacting responsible parties, and ultimately, removing the barrels and contaminated soil), and not on remedying the alleged damage to groundwater and other natural resources ("remedial" costs). . . .

I. Past Costs

. . . . We turn now to the EPA's first contention that the state's removal costs are not capable of apportionment.

Removal Costs

. . . . In light of the fact that most of the waste could not be identified, and that the appellants, and not the government, had the burden to account for all of this uncertainty, we think it plain that the district court did not err in holding them jointly and severally liable for the state's past removal costs. Perhaps in this situation the only way appellants could have demonstrated that they were limited contributors would have been to present specific evidence documenting the whereabouts of their waste at all times after it left their facilities. But far from doing so, appellants deny all knowledge of how their waste made its way to the site.   Moreover, the government presented evidence that much of Rohm and Haas' waste found at the site came from its laboratory in Spring House, Pennsylvania and that during the relevant years, this lab generated over two thousand drums of waste, all of which were consigned to a single transporter. Under these circumstances, where Rohm and Haas was entrusting substantial amounts of waste to a single transporter who ultimately proved unreliable, we simply cannot conclude, absent evidence to the contrary, that only a handful of the 2,000 or more barrels reached the site.

II. Future Liability

. . . Appellants contend that it was improper to hold them liable for future remedial action because the state has not shown that such work will ever be needed. They do not claim, however, that if remedial action is shown to be necessary, it would be a mistake to assume that their waste contributed to the damage. We see no problem with the court giving the state (and EPA) time to conduct further tests. If after conducting the necessary tests, the government concludes that there was in fact no harm to the area's groundwater, then appellants will have nothing to worry about. Moreover, the district court ruled that under section 107 of the Act, the state may take only such measures as are cost-efficient. Appellants, therefore, will have an opportunity to challenge the state's chosen remedial measures at the appropriate time.

Conclusion

Appellants have argued ably that they should not have been held jointly and severally liable. In the end, however, we think they have not satisfied the stringent burden placed on them by Congress. As to all other issues, we affirm substantially for the reasons set out by the district court. n5 Appellants should now move on to their contribution action where their burden will be reduced and the district court will be free to allocate responsibility according to any combination of equitable factors it deems appropriate. Indeed, there might be no reason for the district court to place any burden on appellants. If the defendants in that action also cannot demonstrate that they were limited contributors, it is not apparent why all of the parties could not be held jointly and severally liable. However, we leave this judgment to the district court. . . .

Affirmed.

……………………

Footnotes:

n1 Appellants apparently were offered settlements, but chose instead to try this case.

n5 One of these other issues concerns the constitutionality of applying CERCLA retroactively. The district court held that CERCLA may be applied to pre-enactment conduct. Appellants contend, however, that even if the statute may be applied to pre-enactment conduct, it may not be applied constitutionally to pre-enactment costs incurred by the government . . . We disagree and find persuasive the Eighth Circuit's reasoning . . . .

United States of America, Plaintiff-Appellee, v. Fleet Factors Corp., Defendant

United States Court of Appeals for the Eleventh Circuit

901 F.2d 1550
(May 23, 1990)

Appeal from the United States District Court for the Southern District of Georgia.

JUDGES: Vance and Kravitch, Circuit Judges, and Lynne, Senior District Judge. Opinion by: Kravitch

Fleet Factors Corporation ("Fleet") brought an appeal from the district court's denial of its motion for summary judgment in this suit by the United States to recover the cost of removing hazardous waste from a bankrupt textile facility. The district court denied summary judgment because it concluded that Fleet's activities at the facility might rise to the level of participation in management sufficient to impose liability under the Comprehensive Environmental Response Compensation and Liability Act ("CERCLA"), 42 U.S.C. §§ 9601, despite the statutory exemption from liability for holders of a security interest. We agree with the district court that material questions of fact remain as to the extent of Fleet's participation in the management of the facility; therefore, we affirm the denial of Fleet's summary judgment motion.

FACTS

In 1976, Swainsboro Print Works ("SPW"), a cloth printing facility, entered into a "factoring" agreement with Fleet in which Fleet agreed to advance funds against the assignment of SPW's accounts receivable. As collateral for these advances, Fleet also obtained a security interest in SPW's textile facility and all of its equipment, inventory, and fixtures. In August, 1979, SPW filed for bankruptcy under Chapter 11. The factoring agreement between SPW and Fleet continued with court approval. In early 1981, Fleet ceased advancing funds to SPW because SPW's debt to Fleet exceeded Fleet's estimate of the value of SPW's accounts receivable. On February 27, 1981, SPW ceased operations and began to liquidate its inventory. Fleet continued to collect on the accounts receivable assigned to it under the Chapter 11 factoring agreement. In December 1981, SPW was adjudicated a bankrupt under Chapter 7 and a trustee assumed title and control of the facility.

In May 1982, Fleet foreclosed on its security interest in some of SPW's inventory and equipment, and contracted with Baldwin Industrial Liquidators ("Baldwin") to conduct an auction of the collateral. Baldwin sold the material "as is" and "in place" on June 22, 1982; the removal of the items was the responsibility of the purchasers. On August 31, 1982, Fleet allegedly contracted with Nix Riggers ("Nix") to remove the unsold equipment in consideration for leaving the premises "broom clean." Nix testified in deposition that he understood that he had been given a "free hand" by Fleet or Baldwin to do whatever was necessary at the facility to remove the machinery and equipment. Nix left the facility by the end of December, 1983.

On January 20, 1984, the Environmental Protection Agency ("EPA") inspected the facility and found 700 fifty-five gallon drums containing toxic chemicals and 44 truckloads of material containing asbestos. The EPA incurred costs of nearly $400,000 in responding to the environmental threat at SPW. On July 7, 1987, the facility was conveyed to Emanuel County, Georgia, at a foreclosure sale resulting from SPW's failure to pay state and county taxes.

The government sued the two principal officers and stockholders of SPW, and Fleet to recover the cost of cleaning up the hazardous waste.

DISCUSSION

The Comprehensive Environmental Response Compensation and Liability Act was enacted by Congress in response to the environmental and public health hazards caused by the improper disposal of hazardous wastes.. . . The essential policy underlying CERCLA is to place the ultimate responsibility for cleaning up hazardous waste on "those responsible for problems caused by the disposal of chemical poison.". . . Accordingly, CERCLA authorizes the federal government

to clean up hazardous waste dump sites and recover the cost of the effort from certain categories of responsible parties. . . .

The parties liable for costs incurred by the government in responding to an environmental hazard are: 1) the present owners and operators of a facility where hazardous wastes were released or are in danger of being released; 2) the owners or operators of a facility at the time the hazardous wastes were disposed; 3) the person or entity that arranged for the treatment or disposal of substances at the facility; and 4) the person or entity that transported the substances to the facility. . . . The government contends that Fleet is liable for the response costs associated with the waste at the SPW facility as either a present owner and operator of the facility, or the owner or operator of the facility at the time the wastes were disposed. . .

The district court, as a matter of law, rejected the government's claim that Fleet was a present owner of the facility. The court, however, found a sufficient issue of fact as to whether Fleet was an owner or operator of the SPW facility at the time the wastes were disposed to warrant the denial of Fleet's motion for summary judgment. On appeal each party contests that portion of the district court's order adverse to their respective interests.

A. Fleet's Liability

. . . . CERCLA imposes liability on "any person who at the time of disposal of any hazardous substance owned or operated any . . . facility at which such hazardous substances were disposed of. . . ." . . . CERCLA excludes from the definition of "owner or operator" any "person, who, without participating in the management of a . . . facility, holds indicia of ownership primarily to protect his security interest in the . . . facility." . . . . Fleet has the burden of establishing its entitlement to this exemption. There is no dispute that Fleet held an "indicia of ownership" in the facility through its deed of trust to SPW, and that this interest was held primarily to protect its security interest in the facility. The critical issue is whether Fleet participated in management sufficiently to incur liability under the statute.

The construction of the secured creditor exemption is an issue of first impression in the federal appellate courts. The government urges us to adopt a narrow and strictly literal interpretation of the exemption that excludes from its protection any secured creditor that participates in any manner in the management of a facility. We decline the government's suggestion because it would largely eviscerate the exemption Congress intended to afford to secured creditors. Secured lenders frequently have some involvement in the financial affairs of their debtors in order to insure that their interests are being adequately protected. To adopt the government's interpretation of the secured creditor exemption could expose all such lenders to CERCLA liability for engaging in their normal course of business.

Fleet, in turn, suggests that we adopt the distinction delineated by some district courts between permissible participation in the financial management of the facility and impermissible participation in the day-to-day or operational management of a facility. . . .

The court, however, determined that the facts alleged by the government with respect to Fleet's involvement after Baldwin entered the facility were sufficient to preclude the granting of summary judgment in favor of Fleet on this issue. . . . It is not necessary for the secured creditor actually to involve itself in the day-to-day operations of the facility in order to be liable — although such conduct will certainly lead to the loss of the protection of the statutory exemption. Nor is it necessary for the secured creditor to participate in management decisions relating to hazardous waste. Rather, a secured creditor will be liable if its involvement with the management of the facility is sufficiently broad to support the inference that it could affect hazardous waste disposal decisions if it so chose. . . .

This construction of the secured creditor exemption, while less permissive than that of the trial court, is broader than that urged by the government and, therefore, should give lenders some latitude in their dealings with debtors without exposing themselves to potential liability. Nothing in our discussion should preclude a secured creditor from monitoring any aspect of a debtor's business. Likewise, a secured creditor can become involved in occasional and discrete financial decisions relating to the protection of its security interest without incurring liability.

Our interpretation of the exemption may be challenged as creating disincentives for lenders to extend financial assistance to businesses with potential hazardous waste problems and encouraging secured creditors to distance themselves from the management actions, particularly those related to hazardous wastes, of their debtors. . . . As a

result, the improper treatment of hazardous wastes could be perpetuated rather than resolved. These concerns are unfounded.

Our ruling today should encourage potential creditors to investigate thoroughly the waste treatment systems and policies of potential debtors. If the treatment systems seem inadequate, the risk of CERCLA liability will be weighed into the terms of the loan agreement. Creditors, therefore, will incur no greater risk than they bargained for and debtors, aware that inadequate hazardous waste treatment will have a significant adverse impact on their loan terms, will have powerful incentives to improve their handling of hazardous wastes.

Similarly, creditors' awareness that they are potentially liable under CERCLA will encourage them to monitor the hazardous waste treatment systems and policies of their debtors and insist upon compliance with acceptable treatment standards as a prerequisite to continued and future financial support. . . . Once a secured creditor's involvement with a facility becomes sufficiently broad that it can anticipate losing its exemption from CERCLA liability, it will have a strong incentive to address hazardous waste problems at the facility rather than studiously avoiding the investigation and amelioration of the hazard. . . . .

We agree with the court below that the government has alleged sufficient facts to hold Fleet liable. . . . From 1976 until SPW ceased printing operations on February 27, 1981, Fleet's involvement with the facility was within the parameters of the secured creditor exemption to liability. During this period, Fleet regularly advanced funds to SPW against the assignment of SPW's accounts receivable, paid and arranged for security deposits for SPW's Georgia utility services, and informed SPW that it would not advance any more money when it determined that its advanced sums exceeded the value of SPW's accounts receivable.

Fleet's involvement with SPW, according to the government, increased substantially after SPW ceased printing operations at the Georgia plant on February 27, 1981, and began to wind down its affairs. Fleet required SPW to seek its approval before shipping its goods to customers, established the price for excess inventory, dictated when and to whom the finished goods should be shipped, determined when employees should be laid off, supervised the activity of the office administrator at the site, received and processed SPW's employment and tax forms, controlled access to the facility, and contracted with Baldwin to dispose of the fixtures and equipment at SPW. These facts, if proved, are sufficient to remove Fleet from the protection of the secured creditor exemption. Fleet's involvement in the financial management of the facility was pervasive, if not complete. Furthermore, the government's allegations indicate that Fleet was also involved in the operational management of the facility. Either of these allegations is sufficient as a matter of law to impose CERCLA liability on a secured creditor. The district court's finding to the contrary is erroneous.

With respect to Fleet's involvement at the facility from the time it contracted with Baldwin in May 1982 until Nix left the facility in December 1983, we share the district court's conclusion that Fleet's alleged conduct brought it outside the statutory exemption for secured creditors. Indeed, Fleet's involvement would pass the threshold for operator liability. . . . The scope of the secured creditor exemption is not determined by whether the creditor's activity was taken to protect its security interest. What is relevant is the nature and extent of the creditor's involvement with the facility, not its motive. To hold otherwise would enable secured creditors to take indifferent and irresponsible actions toward their debtors' hazardous wastes with impunity by incanting that they were protecting their security interests. Congress did not intend CERCLA to sanction such abdication of responsibility.

CONCLUSION

. . . Although the court erred in construing the secured creditor exemption to insulate Fleet from CERCLA liability for its conduct prior to June 22, 1982, it correctly ruled that Fleet was liable for its subsequent activities if the government could establish its allegations. Because there remain disputed issues of material fact, the case is remanded for further proceedings consistent with this opinion.

AFFIRMED and REMANDED.

VIII. PERSONAL PROPERTY

KAREN SPANN GRANDE, as Representative of the Estate of Robert A. Spann, Deceased, Petitioner/Appellee, v. SARINA JENNINGS; CLINTON MCCALLUM, Respondents/Appellants

Court of Appeals of Arizona

229 Ariz. 584; 278 P.3d 1287

May 31, 2012, Filed

JUDGES: MAURICE PORTLEY, Presiding Judge. CONCURRING: ANN A. SCOTT TIMMER, Judge, ANDREW W. GOULD, Judge.

OPINION BY: MAURICE PORTLEY, Judge

This case asks us to resolve who owns the money found in the walls of a Paradise Valley home: the estate of the home's former owner or the couple who owned the home at the time of the discovery. The new homeowners appeal the summary judgment granted to the estate, and claim that the funds were abandoned when the home was sold "as is." For the following reasons, we affirm the judgment.

FACTUAL AND PROCEDURAL BACKGROUND

Robert A. Spann lived in his Paradise Valley home until he passed away in 2001. His daughter, Karen Spann Grande ("Grande"), became the personal representative of his estate. She and her sister, Kim Spann, took charge of the house and, among other things, had some repairs made to the home.

They also looked for valuables their father may have left or hidden. They knew from experience that he had hidden gold, cash, and other valuables in unusual places in other homes. Over the course of seven years, they found stocks and bonds, as well as hundreds of military-style green ammunition cans hidden throughout the house, some of which contained gold or cash.

The house was sold "as is" to Sarina Jennings and Clinton McCallum ("Jennings/McCallum") in September 2008. They hired Randy Bueghly and his company, Trinidad Builders, Inc., to remodel the dilapidated home. Shortly after the work began, Rafael Cuen, a Trinidad employee, discovered two ammunition cans full of cash in the kitchen wall, went looking, and found two more cash-filled ammo cans inside the framing of an upstairs bathroom.

After Cuen reported the find to his boss, Bueghly took the four ammo cans but did not tell the new owners about the find, and tried to secret the cans. Cuen, however, eventually told the new owners about the discovery and the police were called. The police ultimately took control of $500,000, which Bueghly had kept in a floor safe in his home.

Jennings/McCallum sued Bueghly for fraudulent misrepresentation, conversion, and a declaration that Bueghly had no right to the money, and Bueghly later filed a counterclaim for a declaration that he was entitled to the found funds. In the meantime, Grande filed a petition in probate court on behalf of the estate to recover the money. The two cases were consolidated in June 2009.

The estate filed a motion for summary judgment and argued that Jennings/McCallum had no claim to the money found in the home. After briefing, the motion was granted. The trial court found that there were "no questions of material fact as to whether Robert A. Spann abandoned or mislaid the currency found in the house purchased by [Jennings/McCallum]" and that the estate did not waive its rights because "[the personal representative] claimed the property as soon as she became aware of it." Final judgment was entered on January 12, 2011, leading to this appeal.

DISCUSSION

Jennings/McCallum argue that summary judgment was inappropriate because there was a genuine issue of material fact as to whether the estate had abandoned its rights to the found money. Specifically, they assert that a jury could have found that Grande "consciously ignored" the possibility that additional large sums of money could be hidden in the home because she did not locate all of the cash that her father had withdrawn from the bank and did not systematically

search all potential hiding spots; therefore, the estate abandoned any rights it had when the house was sold. As a result, Jennings/McCallum argue, they are entitled to the discovered funds.

A.

Summary judgment is appropriate "if the facts produced in support of the claim or defense have so little probative value, given the quantum of evidence required, that reasonable people could not agree with the conclusion advanced by the proponent of the claim or defense." *Orme Sch. v. Reeves*, 166 Ariz. 301, 309, 802 P.2d 1000, 1008 (1990).

B.

Although elementary school children like to say "finders keepers," the common law generally categorizes found property in one of four ways. Found property can be mislaid, lost, abandoned, or treasure trove. Property is "mislaid" if the owner intentionally places it in a certain place and later forgets about it. "Lost" property includes property the owner unintentionally parts with through either carelessness or neglect. "Abandoned" property has been thrown away, or was voluntarily forsaken by its owner. Property is considered "treasure trove" if it is verifiably antiquated and has been "concealed [for] so long as to indicate that the owner is probably dead or unknown."

A finder's rights depend on how a court classifies the found property. In characterizing the property, a court should consider all of the particular facts and circumstances of the case. Under the common law, "the finder of lost or abandoned property and treasure trove acquires a right to possess the property against the entire world but the rightful owner regardless of the place of finding." A finder of mislaid property, however, must turn the property over to the premises owner, "who has the duty to safeguard the property for the true owner."

Significantly, among the various categories of found property, "only lost property necessarily involves an element of involuntariness." *Corliss*, 34 P.3d at 1104 (citation omitted). The remaining categories entail intentional and voluntary acts by the rightful owner in depositing property in a place where someone else eventually discovers it. For example, the Iowa Supreme Court has stated that "[m]islaid property is voluntarily put in a certain place by the owner who then overlooks or forgets where the property is," and that one who finds mislaid property does not necessarily attain any rights to it because possession "belongs to the owner of the premises upon which the property is found," absent a claim by the true owner. *Benjamin*, 534 N.W.2d at 406 (citation omitted). In *Benjamin*, the court determined that packets of money found in a sealed panel of a wing during an inspection of a repossessed airplane were mislaid property because the money was intentionally placed there by one of the two prior owners.

Arizona follows the common law. In order to abandon personal property, one must voluntarily and intentionally give up a known right. . . .

C.

Here, it is undisputed that Spann placed the cash in the ammunition cans and then hid those cans in the recesses of the house. He did not, however, tell his daughters where he had hidden the cans before he passed away. His daughters looked for and found many of the ammo cans, but not the last four. In fact, it was not until the wall-mounted toaster oven and bathroom drywall were removed that Cuen found the remaining cash-filled cans. As a result, and as the trial court found, the funds are, as a matter of law, mislaid funds that belong to the true owner, Spann's estate.

Other state courts have also characterized found money as mislaid funds. For example, the Oregon Supreme Court held that cash, which was wrapped in oiled paper, placed in waterproof containers, and found lodged in the bottom of a natural water pool on the decedent's property, belonged to him at his death, and was mislaid rather than abandoned, lost, or treasure trove property. Similarly, the Arkansas Supreme Court affirmed the trial court's finding that a dusty cardboard box containing about $38,000 and found in the ceiling of a motel room during renovation was mislaid property because "'the money . . . was intentionally placed where it was found for its security, in order to shield it from unwelcome eyes . . . .'" As a result, the court affirmed the determination that the motel owner's rights to the funds were superior to those of the whole world except the true owner.

D.

Jennings/McCallum assert, however, that the mislaid funds were abandoned because Grande consciously ignored the fact that neither she nor her sister had found all of the money that their father had withdrawn from his bank account, and did not do more to find it. We disagree.

First, abandonment is generally not presumed, but must be proven. Here, the facts are undisputed that the estate did not know that the money was mislaid, and did not intend to abandon the funds. In fact, the evidence is to the contrary; once Grande learned of the discovery, she filed a probate petition to recover the property.

Further, *City of Everett v. Sumstad's Estate*, 95 Wn.2d 853, 631 P.2d 366 (Wash. 1981), does not support the argument that a seller may not use "conscious ignorance" as a shield "to protect her right to concealed valuables discovered after a sale." In *Sumstad's Estate*, the buyers purchased a safe at an auction for $50. They were told that the safe had a locked compartment and the auctioneer did not have the key. After hiring a locksmith to open the compartment, the buyers found nearly $32,000. The court, after examining each party's outward manifestations of intent, determined "that the parties mutually assented to enter into that sale of the safe and the contents of the locked compartment."

Here, the house, unlike the safe, was not sold with the thought that there may be cash within its walls. The only evidence presented to the trial court was that Grande was unaware that anything else of value remained in the house. As a result, and unlike the contract in *Sumstad's Estate*, there was no mutual assent to sell the house with concealed valuables.

Based on the evidence before the trial court, there were no facts from which we could begin to infer that the estate intended to relinquish any valuable items that may have been secreted within the home. . . . In fact, the evidence is to the contrary. Accordingly, summary judgment was appropriately granted.

CONCLUSION

Based on the foregoing, we affirm the summary judgment.

Ziva Jewelry, Inc. v. Car Wash Headquarters, Inc.

Supreme Court of Alabama

897 So. 2d 1011

September 17, 2004, Released

JUDGES: STUART, Justice. Nabers, C.J., and Houston, See, Brown, and Harwood, JJ., concur. Woodall, J., concurs in the result. Lyons, J., recuses himself.

OPINION BY: STUART, Justice

Ziva Jewelry, Inc., appeals from a summary judgment in favor of Car Wash Headquarters, Inc. ("CWH"). We affirm.

Background

Ziva Jewelry, Inc., is a jewelry wholesaler. Stewart Smith was employed by Ziva Jewelry as a traveling sales representative. [1] In connection with that employment, Smith drove his own vehicle to meet with potential customers and traveled with samples of expensive jewelry furnished to him by Ziva Jewelry. Smith testified by deposition that he knew that sales representatives in the jewelry business constantly faced the risk of robbery. Smith stated in his deposition that he was aware that a gang of thieves preyed upon traveling jewelry sales representatives. According to Smith, these thieves are aware of where and when jewelry trade shows are held, and they will follow a jewelry sales representative to and from a jewelry trade show, waiting for an opportunity to steal the jewelry. He testified that he knew that thieves were most likely to strike when the jewelry or the sales representative's car was left unattended.

Smith's practice was to keep the jewelry in the trunk of his vehicle while he was traveling on business.[3] He kept the trunk padlocked, and he kept the only key to the padlock on the key ring with his ignition key.

> 3 The jewelry furnished to Smith was covered under Ziva's insurance policy. However, in order for Ziva's insurance policy to be effective while the jewelry was in the sales representative's possession and in his or her car, the sales representative must be "in or upon the vehicle." Ziva described this as "either on [the representative's] person, with him in the car, or [with him] touching the car." Ziva required its sales representatives to follow this procedure at all times.

On August 10, 2000, Smith was returning from a jewelry trade show; his wife had accompanied him to the trade show. He and his wife stopped at a restaurant in Cullman to eat. While they were in the restaurant, they noticed an unidentified person peeking in the window of the restaurant. After eating, the Smiths returned to their vehicle and drove to Vestavia. While in Vestavia, Smith's wife went into a store to shop and Smith went to get his car washed at Rain Tunnel Car Wash. CWH owns and operates Rain Tunnel. At Rain Tunnel, the driver leaves his vehicle with employees of the car wash, and the vehicle is sent through a wash "tunnel." Upon completion of the wash cycle, an employee drives the vehicle to another area of the car-wash premises to be hand-dried. Once the vehicle is dried, the driver is signaled to retrieve his vehicle.

Smith left his car and his keys with a car-wash employee. The jewelry was locked in the trunk. He did not advise any of the employees of the car wash of the presence of the jewelry. Smith testified that he watched the car as it went through the car-wash tunnel. He watched as the employees dried the vehicle. As he was standing at the counter waiting to pay the cashier, he saw the employee wave a flag, indicating that his car was ready for Smith. Smith then saw the employee walk away from his vehicle. While Smith was standing at the cashier counter waiting to pay, someone jumped into Smith's vehicle and sped off the car-wash premises. The police were telephoned and Smith's car was recovered 15 minutes later; it was undamaged. However, the jewelry was missing from the trunk. The value of the missing jewelry was $851,935; it was never recovered.

Ziva Jewelry sued CWH, alleging that CWH, as bailee, took possession of Smith's vehicle and of the jewelry in the vehicle, but failed to exercise due care to safeguard and to return the bailed vehicle and its contents to Smith. Ziva Jewelry also alleged that CWH breached an oral contract it entered into with Smith to safeguard, to exercise due care in

regard to, and to return Smith's vehicle, including the jewelry in the vehicle, to Smith. Finally, Ziva Jewelry alleged that CWH was negligent in otherwise failing to act reasonably and prudently.

CWH moved for a summary judgment on all counts, asserting that no bailment existed as to the jewelry, that Smith had been contributorily negligent, and that CWH could not be held liable for the criminal acts of a third party. Ziva Jewelry opposed that summary-judgment motion. Ziva Jewelry argued that CWH is liable for failing to properly safeguard Smith's vehicle and that CWH failed to return Smith's vehicle in the same condition in which it received it. Ziva Jewelry also offered the deposition testimony of Chris Finley, a Rain Tunnel employee. Finley testified that, on the day of the incident, he had noticed an unidentified male on the premises of the car wash. Finley testified that he knew that this unidentified male was not an employee of Rain Tunnel and that the male did not appear to be a customer. Ziva Jewelry argued that Finley failed to report this unidentified male as a "suspicious person" and, therefore, failed to follow the procedures set forth in CWH's "manual." Ziva Jewelry also argued that Finley had acted negligently in leaving Smith's car unattended with the keys in the ignition. Finally, Ziva Jewelry offered the testimony of criminologist John Lombardi, who testified that the theft of a vehicle from the premises was foreseeable and that CWH did not comply with generally accepted principles of security and crime prevention for businesses.

Ziva Jewelry argued that because CWH took custody and control of Smith's vehicle, CWH necessarily took custody and control of the contents of Smith's vehicle. Ziva Jewelry argued that its doing so constituted a bailment of the jewelry. Ziva Jewelry also argued that Smith had entrusted his vehicle, including the jewelry, to CWH and that CWH had breached its contract to safeguard that property and to return it in the same condition in which CWH had received it.

The trial court rejected those arguments and entered a summary judgment for CWH. The trial court concluded that no bailment of the jewelry had been created. Without a bailment of the jewelry, Ziva could not establish its claims of negligent failure to safeguard the jewelry and breach of a contract to safeguard the jewelry. Ziva Jewelry appeals.

Standard of Review

We agree with the trial court that Smith's vehicle was the subject of a bailment. Smith delivered his vehicle to CWH for the specific purpose of having the car washed. He paid a fee for that service. As a result, CWH owed Smith a duty to use reasonable or ordinary care with regard to Smith's vehicle.

> "A bailment is defined as the delivery of personal property by one person to another for a specific purpose, with a contract, express or implied, that the trust shall be faithfully executed, and the property returned or duly accounted for when the special purpose is accomplished, or kept until the bailor reclaims it. In order for a bailment to exist the bailee must have voluntarily assumed the custody and possession of the property for another."

However, the above-quoted statement of the law on bailment does not answer the question whether a bailment was created as to the contents of the trunk of Smith's vehicle. The trial court correctly noted that no Alabama cases have directly addressed the issue whether a bailee is liable for the loss of contents hidden inside a bailed item. However, the trial court cited other jurisdictions that have addressed this issue.

In *Jack Boles Services*, the Texas Court of Appeals addressed whether a valet-parking service was liable for a valuable painting taken when the vehicle it was in was stolen from the parking lot of a country club. The painting was hidden in the trunk of the stolen vehicle. The Texas Court of Appeals held that the valet service had no duty of care in regard to the undisclosed painting in the vehicle. That court stated:

> "The general rule in other jurisdictions is that a bailee is liable for lost property of which it has actual knowledge as well as property it could reasonably expect to find contained inside a bailed item of which it has express knowledge. ... In Texas, similarly, a bailee is liable for the contents of a bailed vehicle if the contents were (1) in plain view when the vehicle was bailed or (2) constitute the usual, ordinary equipment of a car, such as articles contained in a trunk, which are reasonably anticipated to be there."

In *Jack Boles*, when the parking-service employees accepted responsibility for the vehicle, they had no knowledge that a valuable painting was in the trunk. The court noted that the parking-service employees had no reason to expect that an expensive painting would be in the trunk of the vehicle. For those reasons, the court concluded that the valet-parking service could not be charged with accepting responsibility for the painting merely by accepting responsibility for the vehicle.

We agree with and adopt the reasoning of *Jack Boles*. In this case, Ziva Jewelry cannot establish that CWH expressly or impliedly agreed to take responsibility for the jewelry hidden inside Smith's trunk. Ziva Jewelry acknowledges that the jewelry was not plainly visible; that its presence was not made known to the car-wash employees; and that there was no

reason that the employees should have expected expensive jewelry to be in the trunk of Smith's vehicle. Thus, Ziva Jewelry cannot claim that CWH knew or that it should have reasonably foreseen or expected that it was taking responsibility for over $850,000 worth of jewelry when it accepted Smith's vehicle for the purpose of washing it.

Thus, there is no evidence indicating that CWH expressly or impliedly accepted responsibility for the jewelry in the trunk of Smith's vehicle. Without express or implied acceptance by the purported bailee, a bailment cannot arise. We agree with the trial court that the breach-of-contract claims asserted by Ziva Jewelry fail as a matter of law.

We next address Ziva Jewelry's general negligence claim — that the employee of Rain Tunnel failed to follow CWH's company procedures and that this failure proximately caused the theft of Smith's vehicle and the theft of the jewelry. Ziva Jewelry specifically points out that Finley failed to report the presence of a suspicious person on the property of the car wash and that he left Smith's vehicle unattended, with the keys in the ignition. These failures, Ziva Jewelry alleges, resulted in the loss of the jewelry, when someone stole Smith's vehicle.

While it may be true that Finley failed to follow CWH's procedures, Ziva Jewelry fails to acknowledge that the criminal act of a third party intervened to cause the loss of which it complains. A third party stole the jewelry from Smith's vehicle.

We cannot impose upon CWH a duty for the criminal act of the thief in this case. We cannot say that the particular criminal conduct at issue in this case — the theft of valuable jewelry from Smith's vehicle — was foreseeable to CWH, or that CWH possessed any specialized knowledge of the criminal activity at issue or that the theft of the jewels from the vehicle was a probability. . . .

Ziva Jewelry argues that CWH has admitted in this case that it had a duty to protect its customers. In support of this argument, Ziva Jewelry relies on the testimony of the president of CWH, who acknowledged that CWH's employees are instructed to take certain precautions to prevent losses and thefts affecting both the car wash and the customers of the car wash. However, this testimony was unrelated to the theft of valuables from customer's vehicles and is inapplicable to the analysis in this case.

CWH had no duty to protect Ziva Jewelry from the specific criminal act at issue in this case -- the theft by a third person of the jewelry belonging to Ziva Jewelry from Smith's vehicle. For these reasons, CWH cannot be liable under a negligence theory for the theft of that jewelry. We affirm the trial court's summary judgment in favor of CWH.

AFFIRMED.

Nabers, C.J., and Houston, See, Brown, and Harwood, JJ., concur.

Woodall, J., concurs in the result.
Lyons, J., recuses himself.

IX. REAL PROPERTY

MICHAEL WHELAN ET AL., *Respondents*, v. ALLEN LOUN ET AL., *Appellants*.

Court of Appeals of Washington, Division Three

2011 Wash. App. LEXIS 2768

December 8, 2011, Filed

JUDGES: Dennis J. Sweeney, J. WE CONCUR: Teresa C. Kulik, C.J., Stephen M. Brown, J.

OPINION BY: Dennis J. Sweeney

¶1 SWEENEY, J. -- This suit for adverse possession was resolved by summary judgment. We conclude correctly so. The record before us shows the requisite open, notorious, actual, uninterrupted, exclusive, and hostile possession for 22 years. We therefore affirm the judgment of the trial court.

FACTS

¶2 Michael and Lynn Whelan own real property in Kittitas County. Allen and Michelle Loun own property immediately north of the Whelans' property. Ms. Loun removed a cinderblock and wood fence that ran east and west between the two lots in July 2008. The fence had been there for at least 22 years. But it was not situated on the legally described boundary line. This dispute is over the 12.25-foot strip of land that lies south of where the fence had been situated.

¶3 The Whelans purchased their property from Mr. and Ms. James Vasquez in 2008. The Louns purchased their property from Mr. and Ms. Herbert Zurflueh in 2006. Robert and Suzie Haberman owned and lived on the Whelan property from 1986 to 1990. The fence had been in existence since at least 1986 and, according to Mr. Haberman, "was always considered the boundary between my property and that to the north." Clerk's Papers (CP) at 46 (Decl. of Haberman). Mr. Haberman maintained and repaired the fence as well as the property south of the fence and treated it as his own.

¶4 The fence was still in the same location when Mr. Vasquez and his wife purchased the property in 1998. And he "maintained and repaired the fence and took care of all of the property to the south of the fence" during the 10 years that he owned the property. CP at 37 (Decl. of Vasquez). Mr. Vasquez considered the fence jointly owned by him and the property owners to the north because it was in fact the boundary line between the properties. Mr. Vasquez and Ms. Loun apparently had a conversation at one point about the fence not being on the actual survey line but nothing was done.

¶5 The Whelans sued in June 2008 to quiet title in the 12.25-foot strip of land; they claimed adverse possession. They moved for summary judgment. The court concluded that "[o]ther than a conversation between Loun and Vasquez as noted above, no evidence exists to rebut the Haberman and Vasquez assertions they treated all the property south of the fence as their property and that the fence was [the] boundary line" and quieted title in the Whelans. CP at 91.

DISCUSSION

¶6 The Louns contend that the matter should not have been resolved on summary judgment because disputed issues of material fact remained. They argue that they made a showing that Mr. Vasquez clearly knew the property to the south of the fence did not belong to him; that the strip of land was unkempt and unused; that Ms. Loun gave Mr. Vasquez permission to use the disputed strip of property; and finally that the Whelans should not be allowed to include the time the property was held by previous owners.

¶7 We review a trial court's summary judgment grant de novo; we engage in the same inquiry as the trial court. *Lilly v. Lynch*, 88 Wn. App. 306, 311-12, 945 P.2d 727 (1997). That is, we look to see whether there is a genuine issue of material fact and whether the established facts require the conclusion that the property was adversely possessed. *Id.*

¶8 The Whelans had to show that their possession of the disputed property was open and notorious, actual and uninterrupted, exclusive, hostile, and continued for a period of 10 years. *Bryant v. Palmer Coking Coal Co.*, 86 Wn. App. 204, 209-10, 936 P.2d 1163 (1997). And "[w]here there is privity between successive occupants holding continuously and adversely to the true title holder, the successive periods of occupation may be tacked to each other to compute the required 10-year period of adverse holding." *Roy v. Cunningham*, 46 Wn. App. 409, 413, 731 P.2d 526 (1986). "The ultimate test is the exercise of dominion over the land in a manner consistent with actions a true owner would take." *ITT Rayonier, Inc. v. Bell*, 112 Wn.2d 754, 759, 774 P.2d 6 (1989).

¶9 The Whelans must, of course, rely on the conduct of their predecessors in interest to tack on the necessary period of time for adverse possession. And they did so. Mr. Haberman (1986-1990) and Mr. Vasquez (1998-2008) both declared that the fence was in the same location and general condition as when they owned the property. The fence has then demarcated the boundary line for at least 22 years. Mr. Vasquez declared that he considered the fence jointly owned, but emphasized that he thought it marked the boundary line between the two properties. The Louns argue that Mr. Vasquez accepted that the property did not belong to him because he made a comment in the past about a tree branch hanging over the purported boundary. The Louns would have us infer knowledge on the part of Mr. Vasquez from this conversation. This is an inference that the trial court refused to make and one that we too must refuse to make. The Louns' showing is insufficient to raise the genuine issue of material fact necessary to avoid summary judgment here. It is not use, occupancy, or some claim of right to the disputed property. *Id*. There is also no showing that the property was unkempt or unused. The strip of land sat isolated by the fence in favor of the property owners to the south for some 22 years. Mr. Vasquez repaired and improved the fence, continuously walking across and taking advantage of the 12.25-foot strip of land. This is an exercise of dominion over the disputed strip of land.

¶10 Nor did the Louns show that they gave express or implied permission to Mr. Vasquez to occupy the strip of land. *See Hovila v. Bartek*, 48 Wn.2d 238, 241, 292 P.2d 877 (1956) (the burden is on the true owners to show that the use was permissive). And the Louns present no evidence that they, or their predecessors, used or occupied any of the land south of the fence line. The Whelans and their predecessors have occupied the property south of the fence line for an uninterrupted period of at least 22 years. The possession was hostile, open, and notorious.

¶11 There are no genuine issues of material fact as to ownership of the property as acquired by adverse possession. And the court appropriately resolved the matter summarily in favor of the Whelans.

¶12 We affirm the summary judgment.

¶13 A majority of the panel has determined that this opinion will not be printed in the Washington Appellate Reports but it will be filed for public record pursuant to RCW 2.06.040.

Kulik, C.J., and Brown, J., concur.

HENRY EDSEL FORD, Appellee, v. WILLIAM E. VENARD, Appellant

Supreme Court of Iowa

340 N.W.2d 270 (1983)

November 23, 1983, Filed

OVERVIEW: The landowner purchased land on which the mobile home sat. The owner of the mobile home had substantially modified his residence. He had welded it into a single unit, put a roof over the entire building, and joined the exterior together with siding. The mobile home could not be disassembled without tearing it apart and could not be moved as one unit except by a house mover. The creditor attempted to enforce a judgment against the owner of the mobile home by attaching and forcing execution on the home. The landowner sought an injunction to restrain the creditor from executing upon the judgment, contending that the home was a fixture, which he owned. The trial court granted the injunction. The court affirmed. The home had become attached to the land. It could not be removed from its present location except in the sense that any permanent home could be. It had become an integral part of the real estate.

OUTCOME: The court affirmed the order that granted the landowner's petition for a permanent injunction to restrain the creditor from enforcing a judgment against the mobile home.

JUDGES: Reynoldson, C.J., and Uhlenhopp, Harris, McCormick and McGiverin, JJ.   Opinion: Harris

The question here is whether a mobile home became a part of the realty where it is situated. The trial court found it did and we agree.

This is an equitable action seeking a permanent injunction to restrain defendant from enforcing a judgment. On our de novo review we find the facts to be as follows. In 1973 Norman Van Sickle moved his double-wide mobile home to a plot of land in Silver City, Iowa. He had the real estate landscaped, a foundation poured, concrete blocks set, and steel girders aligned on the blocks. After removing the hitches and wheels, the mobile home was set on the foundation by a crane. It was then hooked together.

Since 1973 Van Sickle has substantially modified his residence. He welded it into a single unit, put a roof over the entire building, and joined the exterior together with siding. It is apparent there is no way the house could be disassembled without tearing it apart and no way it could be moved as one unit except by a house mover.

Luelia Jedlicka, now deceased, was the owner of the land upon which the mobile home was placed. In 1973 Van Sickle paid Jedlicka $500 as down payment on the purchase of the land. He made no other further payments and did not consider himself the owner of the real estate. Van Sickle believed the house belonged to Jedlicka. Van Sickle never received any notice to pay taxes and was told by Jedlicka that she paid them. He had been told by officers of Nebraska Federal Savings and Loan Association of Omaha, which held a security interest on the mobile home, that the house would become a part of Jedlicka's real estate after it was set on a foundation.

In 1977 plaintiff Ford contracted with Jedlicka to buy the land for $3,350. The mobile home, of course, was on it. The land had been appraised in 1977 at $3,000. The value of the house at that time is in dispute. In a 1978 deposition Van Sickle estimated the value to be $16,500. In 1979 Nebraska Federal claimed the actual value was $15,000. At trial Van Sickle testified that the home and land were appraised in 1979 at $10,000.

The contract described the purchased real estate as lots one and two in block twenty-two, "together with all easements and servient estates appurtenant thereto. . . ." Clause seven included all "attached fixtures" as part of the real estate included in the sale.

In 1979 Nebraska Federal brought a replevin action against Van Sickle, Ford and Jedlicka. Ford paid Nebraska Federal $5,000 to settle the action. Ford testified:

> "I appreciated the fact that they had a lien against these homes before they were placed on the property, and it was a legitimate claim, and, although it was a part of the real estate and was a home, there would have been quite a lengthy court suit action over it, and so I and the Savings and Loan came to an agreement and settled on the case out of court."

In 1982 defendant Venard attempted to enforce a 1976 judgment against Van Sickle by attaching and forcing execution on the home. Ford then brought this suit, claiming he owned Van Sickle's home. He asks for an injunction to restrain Venard from executing upon it.

The first question is whether the mobile home was a fixture included under the terms of the land contract between Jedlicka and Ford. We think it plainly was. Under our common law rule personal property becomes a fixture when:

(1) it is actually annexed to the realty, or to something appurtenant thereto;

(2) it is put to the same use as the realty with which it is connected; and

(3) the party making the annexation intends to make a permanent accession to the freehold.

The intention of the party annexing the improvement is the "paramount factor" in determining whether the improvement is a fixture. [cite omitted] "Physical attachment of the structure to the soil or to an appurtenance thereto is not essential to make the structure a part of the realty." On the other hand, a building which cannot be removed without destruction of a substantial part of its value becomes "almost unavoidably an integral part of the real estate. . . ." [cite omitted]

Venard argues that . . . the home was not physically annexed to the realty and that Van Sickle never intended, for purposes outside the present lawsuit, for his home to be permanently attached to the freehold.

Ford maintains, on the other hand, that Van Sickle's home passes the test. He relies on the facts that the home's tongues and wheels have been removed; it was set on a foundation and girders; it has been extensively remodeled into a single unit; and its removal would be expensive and damaging. He points out that the home was used as a homestead, which is the use for which the realty had been appropriated. He points to Nebraska Federal's advice to Van Sickle that his home would become the property of Jedlicka when set on her land.

We have found buildings to be fixtures in a number of cases. [cites omitted]

We are convinced the home became attached to the land. It could not be removed from its present location except in the sense that any permanent home could be. We hold that it has become an integral part of the real estate.

. . . .

The trial court was right in ordering the issuance of the permanent injunction.

Affirmed.

JOAN L. CUNNINGHAM, Plaintiff-Appellant, v. WARREN R. HASTINGS, Defendant-Appellee

Court of Appeals of Indiana, First District

556 N.E.2d 12

June 28, 1990, Filed

JUDGES: Baker, J. Ratliff, C.J. concurs w/opinion; Chezem, P.J. concurs. OPINION BY: BAKER

STATEMENT OF THE CASE

Plaintiff-appellant, Joan L. Cunningham (Cunningham), appeals a judgment entered on her partition action in which the trial court credited defendant-appellee, Warren R. Hastings (Hastings), for the purchase money he provided to obtain certain real estate.

We reverse and remand.

STATEMENT OF THE FACTS

On August 30, 1984, Harold and Juanita Carlton conveyed by warranty deed certain real estate to Cunningham and Hastings. The deed referred to Cunningham and Hastings "as joint tenants with the right of survivorship, and *NOT* as tenants in common," Record at 16 (original emphasis), and was prepared and occupied the property jointly. After the relationship ended and Hastings took sole possession of the property, Cunningham filed a complaint seeking partition of the real estate.

The trial court conducted a hearing after which it determined that Cunningham and Hastings were joint tenants in the property, each with an undivided interest in the whole. Based on its determination that the property was no susceptible of partition, the trial court ordered the sale of the property. IND. CODE 32-4-5-4. The trial court further ordered that the proceeds of the sale be applied first to cover the costs of the partition proceedings, and that the next $ 45,000 be paid to Hastings as a refund of the purchase price he paid out of his own funds. The remainder of the procees, if any, were ordered to be divided equally between the parties. Cunningham appeals the trial court's $45,000 award to Hastings in recognition of the purchase price he paid.

Cunningham presents four issues for our review which are more succinctly stated as the following single issue:

Whether the trial court's judgment was contrary to law when it attempted to equalize the partition by awarding one joint tenant credit for the purchase price.

Although the trial court's judgment granting Cunningham's request for partition was essentially a judgment in her favor, she is nonetheless appealing a negative judgment. In her complaint, she requested the real estate be sold and that the proceeds be divided evenly. Because the trial court did not order Cunningham's request for the even division of the proceeds, its judgment constitutes a negative one. Accordingly, this court will not reverse the trial court's judgment unless it is established to be contrary to law. Aetna Casualty & Sur. Co. v. Crafton (1990), Ind. App., 551 N.E.2d 893.

There is some discussion in the parties' briefs regarding whether Hastings made an inter vivos gift of the real estate of Cunningham. This discussion is not necessary to the disposition of this appeal because the decisive issue involves the determination of what interest Cunningham acquired in the real estate when her name was included on the deed as a joint tenant.

The parties do not dispute that the unequivocal language of the deed created a joint tenancy in the real estate. When a joint tenancy is created, each tenant acquires "an equal right . . . to share in the enjoyment of the land during their lives." Richardson v. Richardson (1951), 121 Ind. App. 523, 528, 98 N.E.2d 190, 192, trans. denied (quoting Case v. Owen (1894), 139 Ind. 22-23, 38 N.E. 395) (emphasis added). A joint tenancy relationship confers equivalent legal rights on the tenants that are fixed and vested at the time the joint tenancy is created. 48A C.J.S. Joint Tenancy § 21 (1981).

This court's decision in Becker v. MacDonald (1986), Ind. App., 488 N.E.2d 729, on reh'g 491 N.E.2d 210, trans. denied, is instructive on the extent of Cunningham's interest in the property. Becker involved a joint tenancy between

three parties consisting of a sister, a brother, and the brother's wife. This court and the trial court denied the sister's claim that she was sole owner of the property. This court stated that once a determination of joint tenancy was made in the partition action, the next question was whether the sister owned a one-half or one-third interest. Based on Becker, the determination of the parties' interests in the present case is simple. There are only two parties involved in the joint tenancy. Once a joint tenancy relationship is found to exist between two people in a partition action, it is axiomatic that each person owns a one-half interest.

Based on the reasoning in Becker, we find that the trial court erred in allowing Hastings a $45,000 credit for the purchase price he paid. Regardless of who provided the money to purchase the land, the creation of a joint tenancy relationship entitles each party to an equal share of the proceeds of the sale upon partition. Equitable adjustments to cotenants' equal shares are allowed when the cotenants hold the property as tenants in common, Paidle v. Hestad (1976), 169 Ind. App. 370, 348 N.E.2d 678, not when they hold as joint tenants. The deed in the case before us unequivocally states that the parties held the property as joint tenants, not as tenants in common. The equitable adjustment of their equal shares, therefore, was improper.

At trial, Hastings presented evidence as to certain expenses he incurred with respect to the real estate. The trial court's judgment did not afford him relief for these expenses. Hastings argues in his brief that if this court reverses the trial court's award of the purchase price, we should remand the case to the trial court for a determination of Hastings' expenses. We decline to do as Hastings suggests because his request for expenses was first made at the hearing on Cunningham's partition action. The expenses claimed by Hastings were properly the subject of a counterclaim because they arose out of the same transaction that formed the basis of Cunningham's complaint. Ind. Trial Rule 13(A). T.R. 13 requires that such matters be promptly raised in the pleadings.. Hastings' failure to include a request for these expenses in his counterclaim resulted in not dispute being placed before the trial court on this issue. We will not rewrite the pleadings for his benefit on appeal.

The trial court's judgment is reversed and the case remanded with instructions to order the proceeds of the sale be divided equally between the joint tenants without credit given for the purchase price.

CONCURRING OPINION

RATLIFF, C.J.

I concur in the majority opinion, and, in so doing, agree that the very nature of joint tenancies involves equal rights on the part of the joint tenants. Richardson v. Richardson (1951), 121 Ind. App. 523, 98 N.E.2d 190, trans. denied. However, I do not agree with the majority's statement that the inter vivos gift issue is not relevant. The fact that Hastings made a valid inter vivos gift to Cunningham is the foundation of the joint tenancy. The joint tenancy was created when Hastings, by having the real estate placed in joint tenancy, made a valid and completed inter vivos gift of an undivided one-half interest, in joint tenancy, to Cunningham. By so doing, he gave away one-half of his contribution of the purchase price and may not revoke his gift and recover back the purchase price. When the property is sold and the net proceeds are divided equally between the two joint tenants, Hastings will receive all he is entitled to receive.

X. Wills & Estates

In Re: Estate of Mildred D. Potter, Deceased

Court of Appeal of Florida, Fourth District

469 So. 2d 957 (1985)

June 5, 1985

JUDGES: Walden, J. Downey and Hersey, JJ., concur.

OPINION BY: WALDEN

Mildred D. Potter died testate. Her will provided:

> In the event my husband, EDWIN E. POTTER, shall not survive me, I bequeath and devise my residence known as 14 Sunset Lane, Pompano Beach, Florida, together with all household goods contained therein to my daughter, HELEN POTTER WANKE, if she shall survive me. If my said daughter does not survive me, this bequest shall lapse and such residence shall be sold by my Executor and the proceeds thereof shall become a part of my residuary estate. It is my intention that the properties specifically bequeathed and devised in accordance with the provisions of this Article II of my Will shall pass to the persons named therein free of administrative expenses and free of any liability for estate and inheritance taxes, and I therefore direct my Executor that the said property shall not be considered assets in its hands for any said purposes.

Contemporaneous with the execution of her will, Mrs. Potter executed an amendment to her preexisting inter vivos trust, which amendment provided that in the event Mrs. Potter's daughter, Helen, did receive the Pompano Beach residence under the terms of the will, then the trustee "shall thereupon pay over to grantor's son, Edwin E. Potter, Jr., an equivalent amount, out of the trust assets before its division into the two trusts for grantor's son and daughter, free of the trust."

The will also provided that any property specifically bequeathed would pass free of administrative expenses and any liability for estate and inheritance taxes and authorized the executor, if necessary, to request sums to be paid from the trust to the estate to pay debts, administration expenses, taxes, etc. The trust also provided for the trust to pay those expenses of the estate.

Mrs. Potter's husband predeceased her so that upon Mrs. Potter's death, the above-stated terms of the will and the trust became operative. Thus, restating the situation, Mrs. Potter, via her will, wanted her daughter to have the residence, free and clear, and, via her inter vivos trust, wanted her son to have a sum in cash equivalent to the value of the residence received by her daughter.

Unfortunately, there were insufficient assets in the trust to pay Mrs. Potter's son the equivalent sum in cash.

At the personal representative's behest, the trial court entered the appealed order which undertook to interpret the will and trust. It was ruled that Mrs. Potter's intent was to treat the son and daughter equally in the distribution of her estate. Since the assets were insufficient to allow the implementation of the literal provisions of both the will and trust, the trial court ordered the sale of the residence; the payment of taxes and all administration expenses; and, the division of the remainder equally between the son and daughter.

While we disagree with the ultimate conclusion reached by the trial court, we do agree with the finding contained in the appealed order that the trust in question was incorporated by reference into Mrs. Potter's will and that they should be thereby construed together in determining Mrs. Potter's intent. *See* § 732.512(1), Fla. Stat. (1983). Moreover, and as a peripheral consequence, the trust provisions then became testamentary dispositions so as to entitle us to use testamentary terms in describing them.

According to our analysis, the disposition of this appeal is governed by the law concerning devises and abatement.

In our opinion the devise of the residence to Mrs. Potter's daughter constituted a specific devise while the trust proviso requiring payment to Mrs. Potter's son of an equivalent sum of money was tantamount to a general devise.

By way of definition, "A specific legacy is a gift by will of property which is particularly designated and which is to be satisfied only by the receipt of the particular property described." *In re Parker's Estate*, 110 So.2d 498, 500 (Fla. 1st DCA 1959).

On the other hand, "A general legacy is one which may be satisfied out of the general assets of the testator's estate instead of from any specific fund, thing or things. It does not consist of a gift of a particular thing or fund or part of the estate distinguished and set apart from others of its kind and subject to precise identification. A general legacy has a prerequisite of designation by quantity or amount. The gift may be either of money or other personal property." *Park Lake Presbyterian Church v. Henry's Estate*, 106 So.2d 215, 217 (Fla. 2d DCA 1958).

It is our further opinion that general devises abate before specific devises. Redfearn, *Wills and Administration in Florida* § 12.08 (5th Ed. 1977), explains such abatement.

> Abatement is the reduction of a legacy or devise on account of the insufficiency of the estate of a testator to pay all his debts, all the costs of administration, and all the legacies in full. The presumption is that the testator intended that all the legacies provided for in his will would be paid in full and that he contemplated that his estate would be sufficient to meet this requirement, but his good intentions are no protection for his legatees and devisees from the just claims of his creditors or from costs of administration. Under the common law and under the probate laws of Florida, the first assets of the estate to be applied to the payment of debts and costs are those charged by the testator with this particular indebtedness; next, the assets not devised; then the assets found in the residuary clause of the will are applied. If these assets are insufficient, or if there is no residuary clause or undevised estate, then general legacies must abate pro rata to make up the deficiency; if the general legacies are insufficient to meet these requirements, then specific and demonstrative legacies abate in the manner set forth in section 12.07.

See also 80 Am.Jur.2d *Wills* § 1736 (1975). The above exposition is supported by the provisions of section 733.805, Florida Statutes (1983):

> (1) If a testator makes provision by his will, or designates the funds or property to be used, for the payment of debts, estate and inheritance taxes, family allowance, exempt property, elective share charges, expenses of administration, and devises, they shall be paid out of the funds or from the property or proceeds as provided by the will so far as sufficient. If no provision is made or any fund designated, or if it is insufficient, the property of the estate shall be used for such purposes, except as otherwise provided in s.733.817 with respect to estate, inheritance, and other death taxes, and to raise the shares of a pretermitted spouse and children, in the following order:
>
> > (a) Property not disposed of by the will.
> >
> > (b) Property devised to the residuary devisee or devisees.
> >
> > (c) Property not specifically or demonstratively devised.
> >
> > (d) Property specifically or demonstratively devised.
>
> (2) Demonstrative devises shall be classed as general devises upon the failure or insufficiency of funds or property out of which payment should be made, to the extent of the insufficiency. Devises to the decedent's surviving spouse, given in satisfaction of, or instead of, the surviving spouse's statutory rights in the estate, shall not abate until other devises of the same class are exhausted. Devises given for a valuable consideration shall abate with other devises of the same class only to the extent of the excess over the amount of value of the consideration until all others of the same class are exhausted. Except as herein provided, devises shall abate equally and ratably and without preference or priority as between real and personal property. When property that has been specifically devised or charged with a devise is sold or taken by the personal representative, other devisees shall contribute according to their respective interests to the devisee whose devise has been sold or taken, and before distribution the court shall determine the amounts of the respective contributions, and they shall be paid or withheld before distribution is made.

We hold that the trust provision in favor of Mrs. Potter's son constituted a general legacy while the will provision in favor of Mrs. Potter's daughter constituted a specific legacy. Thus, under the circumstances, the general legacy abated prior to the specific legacy with the result here being that Mrs. Potter's daughter should receive the Pompano Beach residence.

By reason of the foregoing and upon authority of *In re Estate of George*, 200 So.2d 256 (Fla. 3d DCA 1967), we reverse the judgment on appeal and remand for further proceedings.

Reversed and Remanded.

DOWNEY and HERSEY, JJ., concur.

John E. Bailey, Plaintiff-Appellant, v. Lola F. Clark et al., Defendants-Appellees

Appellate Court of Illinois, Fifth District

203 Ill. App. 3d 1017

September 27, 1990, Filed

JUDGES: Justice Chapman delivered the opinion of the court. Rarick and Welch, JJ., concur.

OPINION: JUSTICE CHAPMAN delivered the opinion of the court:

Everett J. Clark died March 28, 1987. A document purporting to be his last will and testament was admitted to probate March 30, 1987. Harold Clark, a nephew of the decedent, filed a petition to declare the will invalid and a motion to require formal proof of the will. After a hearing the court entered an order setting aside the original order admitting the will to probate, declaring "that there has been insufficient competent evidence by the proponent of the will to establish the will." On December 29, 1987, John Bailey filed a petition contesting the denial of admission of the will to probate. The petition named as parties-respondents Lola Clark, a sister and heir at law of Everett Clark, and Harold Clark, Everett Clark's nephew and administrator of the estate. A jury trial was held on the petition. On September 22, 1988, the jury returned a verdict finding that the purported will "is not the valid last will and testament of Everett Clark." This appeal ensued, following the denial of John Bailey's post-trial motion.

The testimony at trial revealed that Everett Clark was never married and lived with his sister Lola Clark. On March 18, 1987, Everett Clark met with attorney William Wham to discuss the preparation of his last will and testament. Everett was to return to Wham's office the following day to execute the instrument, but developed complications from a perforated ulcer and was hospitalized. He underwent surgery on March 18. Subsequent to surgery and until the time of his death, he was in intensive care and provided with an endotracheal tube attached to a ventilator to help him breathe. The placement of this tube made it impossible for him to communicate orally.

It is undisputed that on March 23, Everett Clark's cousin John Bailey, and Vera Horton, John Bailey's sister-in-law, retrieved the will prepared by William Wham and took it to attorney Frank Walker to have him finalize the execution of the will. Walker testified that he took the instrument to the hospital on March 25 to have Everett Clark execute it. Walker testified that immediately prior to executing the will he asked Everett Clark a few questions to determine whether Clark understood what he was doing.

Dr. Martin, the emergency room physician who attended Clark when he was admitted to the hospital, testified that he followed Clark's case and saw him every day while Clark was in the hospital. Dr. Martin testified that in his medical opinion, on March 25 Everett Clark was alert, competent, and capable of executing legal documents. It was revealed during cross-examination that Everett Clark passed into a coma on March 26. Dr. Martin testified, however, that it was possible that the decedent could have been perfectly competent before noon on March 25, and could have passed into a coma on March 26.

Dorothy Smith, an attesting witness to the will, testified that she had known Everett Clark for eight years and believed him to be of "sound mind and memory and under no undue influence" when she was asked to witness the signing of the will. Immediately prior to signing the will she spoke with Everett Clark. Smith testified that "he couldn't talk verbally, but he could answer in a different way by nodding his head yes and no." She asked Clark "if he knew me and if he knew we were all there and he shook his head yes." Dorothy Smith testified that Mr. Walker then talked with Clark and said, "this is your will and testament, asked if John Bailey was his cousin. He asked if he wanted to leave everything to John Bailey; if he knew everything about this will." When asked by counsel whether Everett Clark indicated to Walker that he knew all about the will, Smith testified that he "didn't indicate that as such. He gave me the impression and I believed the man knew what was going on."

The second attesting witness, Vera Mae Horton, also testified that she had known Clark for eight years and that at the time the will was executed she believed Everett Clark to be of sound mind and memory. She answered affirmatively when asked whether she believed Clark was capable of understanding ordinary business transactions and competent to make a will at the time he signed the document.

When a person executes a will he must possess sufficient mental capacity to know the natural objects of his bounty, to comprehend the character and extent of his property, to understand the particular business in which he is engaged, and to dispose of said property pursuant to a plan formed in his mind. Lay persons may testify in a will contest concerning the issue of testamentary capacity as long as they testify to sufficient facts and circumstances indicating that their opinion is not a guess, speculation or suspicion. No witness testified that he or she believed Everett Clark was lacking in the elements of testamentary capacity on March 25, 1987. All of the witnesses who testified as to the decedent's mental state declared their belief that Clark was of sound mind and memory at the time he signed the will. We find that there was sufficient evidence from which the jury could conclude that the decedent possessed the requisite testamentary capacity to make a will.

The Probate Act of 1975 (Ill. Rev. Stat. 1987) provides that "Every will shall be in writing, signed by the testator or by some person in his presence and by his direction and attested in the presence of the testator by 2 or more credible witnesses." There is no question that the will was in written form. Evidence was presented, however, which raised the question of whether the will was signed as contemplated.

The will consists of two pages. At the bottom of page one is a typed signature line with the name Everett J. Clark typed underneath. Above the signature line is a handwritten "X." Although it is not designated on the instrument that the "X" represents the testator's mark, this is not enough to invalidate the will. A will may be valid where it is signed by mark even though the mark is not accompanied by the testator's name or by the words "his mark." See *In re Will of Westerman* (1948), 401 Ill. 489.

There was testimony that Everett Clark did not mark the "X" without assistance. It was Dr. Martin's testimony that "from the first night post-operative, Mr. Clark pulled his [endotracheal] tube out, so his arms were restrained throughout the time." Attorney Walker testified that when the will was executed he placed a pencil in Everett Clark's hand because Clark's hand was tied down. Walker testified that he helped Everett Clark "find the line and we guided his hand and he made an 'X' and I held the pen in his hand." Dorothy Smith and Vera Mae Horton each confirmed Walker's assisting Everett Clark mark the "X" on the will. Dorothy Smith could not recall whether Clark was asked to make the mark himself, but recalled that he was given a pencil and helped to mark.

If a guide or assisted signature is placed on a will at the request of the person making the will and such person thereafter in the presence of two witnesses acknowledges the instrument to be his will, voluntarily made, the requirements of the statute have been met. There was no testimony presented that Everett Clark requested assistance in marking the "X." There was sufficient evidence presented, however, that Everett Clark's condition necessitated that he be assisted in marking the "X." The greatest dispute in the testimony is whether the testator, in the presence of the attesting witnesses, acknowledged the instrument as his will or was aware of the contents of the document.

William Wham, the attorney who prepared the will, testified that after he prepared the instrument he never had the opportunity to read or review the will with Everett Clark.

Vera Mae Horton testified that prior to March 25, 1987, the will was never read to Everett Clark in her presence. She further testified that she did not know whether the will was read to Everett Clark on March 25. When counsel asked her whether Clark ever told her by any means on March 25, 1987, that the document was his last will and testament, she testified, "no, not me." Horton did testify, however, "When Mr. Walker asked him if this is what — if this was his will and if this is what he wanted and he shook his head, yes."

Smith, the other attesting witness, testified that just prior to Everett Clark's signing the will, she asked him if he knew that the attorney was there, and he responded by nodding affirmatively. She testified that Walker then spoke with Everett Clark and explained to him that "he was there at the last will and testament. * * * He said, this is your will and testament, asked if John Bailey was his cousin * * * if he wanted to leave everything to John Bailey; if he knew everything about the will." When counsel asked Smith whether Clark indicated to the attorney that he knew all about the will, Smith testified, "he didn't indicate that as such * * * I believed the man knew what was going on."

The only witness who testified that the will was read to Everett Clark and that Clark was asked if he wanted to sign the will was attorney Frank Walker. Walker, who represents the proponent in this case, testified that when he asked Clark, after reading the will to him, whether that is what Clark wanted, Clark shook his head yes.

The testimony of the witnesses who attested the execution of the will was not wholly conclusive on the issues of whether Everett Clark acknowledged the instrument as his will or knew the contents of the instrument executed as his will. Although Clark's physical disability alone cannot be considered as evidence that he did not know the contents of the instrument which he executed, based on the testimony presented in the instant case, it was entirely reasonable for the

jury to find that Everett Clark did not acknowledge that the instrument was his will and did not know the contents of the instrument.

On the question of the valid execution of a will in a proceeding for its probate, the question of the credibility of the witnesses is for the court hearing the case, and where it has given credit to the testimony of subscribing witnesses, this court will not disturb its judgment. The credibility of witnesses and the weight to be accorded their testimony are matters for the jury to determine, and unless its determination is manifestly against the weight of the evidence, it will not be disturbed on appeal. We conclude that the record does not support the proponent's contention that the verdict was against the manifest weight of the evidence, and therefore the judgment must be affirmed.

Affirmed.

RARICK and WELCH, JJ., concur.