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ARTICLES



NOTES



COMMENT



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# ARTICLE

# NEW ROLE FOR THE TREASURY: CHARGING INTEREST ON TAX DEFERRAL LOANS

CYNTHIA BLUM*

*The Internal Revenue Code often requires taxpayers to report income when it is earned. However, the Code currently permits tax deferral in certain instances where problems of valuation and liquidity may render accrual taxation impractical or unduly harsh. The resultant delay in recognition of income produces undesirable distortion of economic behavior, unfairly differential treatment of similarly situated taxpayers, and diminished Treasury receipts.*

*In this Article, Professor Blum argues that an interest charge on the amount of deferred tax can substantially alleviate these concerns. She describes several alternative methods of interest charge determination and payment and their applicability in various contexts. She then argues that tax deferral coupled with an interest charge can approximate the accuracy of accrual taxation without causing excessive administrative difficulties. She also argues that an interest provision correcting errors in applying accrual rules can make accrual taxation more acceptable in some cases. Finally, Professor Blum examines the feasibility of an interest charge in the context of several specific deferral provisions of the Code and demonstrates that imposition of an interest charge on deferred taxes would be desirable in most of these instances.*

Contents



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## *Author's Note*

As this Article went to press, Congress was considering legislation that would extend provisions for charging interest on tax deferral loans, as the Article recommends. Specifically, the House of Representatives on October 29, 1987, and the Senate Finance Committee on October 16, 1987, voted to extend the requirement that long-term contracts be reported under the percentage of completion method, and that errors be corrected with a lookback interest charge or credit, to 100% of the items under the contract (as compared with 40% under present law). *See infra* note 14. In addition, the Senate Finance Committee voted to impose an interest charge with respect to tax deferral resulting from the use of the installment method by a nondealer, but only to the extent that the aggregate face amount of the nondealer installment obligations that arise during a taxable year and are outstanding at the close of that year exceeds $5 million. At the same time, the Senate Finance Committee voted to repeal the proportionate disallowance rule, but to provide for special treatment of pledges of installment obligations. *See infra* notes 15 & 331. The bill approved by the House of Representatives, however, does not provide such an interest charge, but merely limits the application of the proportionate disallowance rule for nondealer sales and provides special treatment of pledges of installment obligations. *See infra* note 15.

The Senate Finance Committee voted also to repeal the installment method for dealers, thereby eliminating the need for an interest charge compensating for deferral of tax by dealers. In contrast, the House of Representatives would preserve the use of the installment method with respect to dealer sales (subject to the proportionate disallowance rule and denial of such use under the alternative minimum tax), but restrict such use to 40% of the gross profit from the sale. *See infra* note 12. Both the House and the Senate Finance Committee versions of the legislation retain the option under present law for a dealer to use the installment method with respect to certain sales of time shares and residential lots if he pays an interest charge compensating for tax deferral. *See infra* note 12.

The expanded use of interest provisions being considered by Congress suggests the viability of this approach in other contexts as well, such as professional fees and gain or loss from marketable securities, as discussed in the Article. Moreover, there is a need to focus on issues relating to the proper design of an interest charge under existing and possible new provisions, as is done in the Article.

## I. Background

In some cases, federal income tax provisions permit a taxpayer to delay reporting income that has been earned. The taxpayer is thus able to defer payment of tax. This tax deferral may be viewed as the receipt of an interest-free loan from the Treasury.[1] Proposals to eliminate this tax deferral, and thus to eliminate the loan, must overcome problems of valuation and liquidity. An alternative approach sometimes considered, particularly in the context of capital gains taxation,[2] is for the Treasury to charge interest on these tax deferral loans.[3]

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[1] *See, e.g.*, M. GRAETZ, FEDERAL INCOME TAXATION 341–42 (1985) (deferral likened to interest-free loan). For further discussion of the effects of deferral, see Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1123–28 (1974).

[2] For proposals to impose an interest charge with respect to the tax on capital gains, see CONG. BUDGET OFFICE, REVISING THE INDIVIDUAL INCOME TAX 78–81 (1983); INSTITUTE FOR FISCAL STUDIES, THE STRUCTURE AND REFORM OF DIRECT TAXATION 132–35, 148–49 [hereinafter MEADE COMMISSION REPORT]; Brinner, *Inflation, Deferral and the Neutral Taxation of Capital Gains*, 26 NAT'L TAX J. 565, 570–71 (1973); Brinner & Munnell, *Taxation of Capital Gains: Inflation and Other Problems*, NEW ENG. ECON. REV., Sept.–Oct. 1974, at 3, 12–21; Helliwell, *The Taxation of Capital Gains*, 2 CAN. J. OF ECON. 314 (1969); Wetzler, *Capital Gains and Losses*, in COMPREHENSIVE INCOME TAXATION 115–57 (J. Pechman ed. 1977). For a discussion of such proposals, see D. BRADFORD, UNTANGLING THE INCOME TAX 48–49 (1986); D. BRADFORD AND U.S. TREASURY TAX POLICY STAFF, BLUEPRINTS FOR BASIC TAX REFORM 74 (rev. 2d ed. 1984) [hereinafter BLUEPRINTS]; Andrews, *supra* note 1, at 1147–48; Blum, *Rollover: An Alternative Treatment of Capital Gains*, 41 TAX L. REV. 383, 395–97 (1986) [hereinafter Blum, *Rollover*]; Brinner, *Comments*, in COMPREHENSIVE INCOME TAXATION 154–57 (J. Pechman ed. 1977) [hereinafter Brinner, *Comments*]; Hickman, *Capital Gains and Simplification* in FEDERAL INCOME TAXATION SIMPLIFICATION 223, 244–46 (C. Gustafson ed. 1979); Warren, *Comments*, in COMPREHENSIVE INCOME TAXATION 158–62 (J. Pechman ed. 1977) [hereinafter Warren, *Comments*]. Gann argues that adoption of a deferral charge for capital gains is necessary to "address conscientiously the neutrality goal in taxing capital income," and she criticizes the omission of a deferral charge from recent tax reform proposals. Gann, *Neutral Taxation of Capital Income: An Achievable Goal?*, 48 L. & CONTEMP. PROBS. 77, 109, 145–47 (1985). *See also* Shakow, *Taxation without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111, 1122–24, 1169–70, 1176; Warren, *The Deductibility by Individuals of Capital Losses under the Federal Income Tax*, 40 U. CHI. L. REV. 291, 318–19; Note, *Realizing Appreciation Without Sale: Accrual Taxation of Capital Gains in Marketable Securities*, 34 STAN. L. REV. 857, 872 n.65 (1982); Note, *The Tax Reform Act of 1986: Simplification and the Future Viability of Accrual Taxation*, 62 NOTRE DAME L. REV. 779, 789–91, 794 (1987) [hereinafter Note, *Tax Reform Act*] (discussing proposal by Shakow, *supra*, and criticism of deferral charge by Hickman, *supra*).

[3] *Cf.* Halperin, *Interest in Disguise: Taxing the "Time Value of Money"*, 95 YALE L.J. 506, 531–34 (1986) (discussing possibility of charging interest on a tax deferral loan resulting from an overestimate of a future payment, by segregating amount of estimated payment and requiring inclusion in income of the unused amount and the return received thereon); Land, *Contingent Payments and the Time Value of Money*, 40 TAX LAW. 237, 284–98 (1987) (proposing use of "yield-based approach" with respect to contingent payments). Under the "yield-based approach," a deferral surcharge is imposed when deferred income is recognized equal to the excess of the amount that the taxpayer has accumulated after-tax by reporting income on a deferred basis over the amount that he would have accumulated after-tax absent deferral. This hypothetical after-tax accumulation is determined by applying the after-tax yield to the initial investment; the after-tax yield is determined by multiplying the taxpayer's pre-tax yield by the nominal tax rate applicable in the year of the deferred payment. *See id.*

The main distinguishing feature of the yield-based method is that it measures the value of tax deferral, where possible, by reference to the pre-tax yield of the particular investment (determined by hindsight if there are contingencies), rather than by reference

The Tax Reform Act of 1986 has imposed an interest charge in three different contexts. First, dealers in certain real estate are exempted from new restrictions on use of the installment method on the condition that they pay an interest charge compensating for tax deferral under the installment method.[4] Second, an interest charge (or credit) is payable upon completion of a long-term contract to compensate for deferral (or acceleration) of income resulting from the use of mistaken estimates in applying the percentage of completion method.[5] Third, an interest charge is imposed to compensate for deferral by a United States shareholder of his tax liability with respect to accumulated income of a Passive Foreign Investment Company (PFIC).[6]

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to an assumed rate of interest. *See id.* at 287. While this might also be a feature of an interest charge, it need not be. In many cases, this feature of the yield-based approach is not present, however, since it is not possible directly to determine the pre-tax yield of the particular investment; instead the pre-tax yield must be determined by reference to a market interest rate. *See infra* notes 35–38 and accompanying text. In some other cases, the pre-tax yield can be determined by hindsight based on the assumption of a constant yield over the holding period, but this assumption is not uniformly valid. In those cases, the appropriateness of using either the yield-based method or the interest charge method is subject to doubt. *See infra* notes 196–206 and accompanying text.

While the yield-based method is always applied retrospectively, an interest charge may be determined and made payable on a current basis. *See infra* text accompanying notes 81–83. For a comparison of the steps involved in applying each of the two methods on a retrospective basis, see *infra* note 284.

[4] I.R.C. § 453C(e)(4)(B), (C), *added by* Tax Reform Act of 1986, Pub. L. No. 99-514, § 811(a), 100 Stat. 2085 [hereinafter TRA 1986]. This election permits dealers in certain time shares and residential lots to apply the installment method without regard to the proportionate disallowance rule. For legislative history, see S. REP. No. 313, 99th Cong., 2d Sess. 129–30 (1986) [hereinafter SENATE REPORT]; H.R. REP. No. 841, 99th Cong., 2d Sess. II-299 (1986) [hereinafter CONFERENCE REPORT]. *See also* STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 497 (1987) [hereinafter BLUEBOOK].

[5] I.R.C. § 460(a)(2), (b)(2)–(3) (1986), *added by* TRA 1986, *supra* note 4, § 804(a). The taxpayer may elect to apply the percentage of completion method with respect to 40% or 100% of the items under the contract. *See id.* For legislative history, see H.R. REP. No. 426, 99th Cong., 1st Sess. 630–31 (1986) [hereinafter HOUSE REPORT]; CONFERENCE REPORT, *supra* note 4, at II-310 to -313. *See also* BLUEBOOK, *supra* note 4, at 524–30. *See generally* I.R.S. Notice 87-61, 1987-38 I.R.B. 40 (procedures for change of method of accounting pursuant to section 460 of the Code and an elective, simplified method for determining percentage of completion). Under the Bradley-Gephardt bill, taxpayers would have been permitted to use the completed contract method with respect to 100% of the items under the contract, but would have been required to pay an interest charge compensating for deferral under that method. S. 409, 99th Cong., 1st Sess. § 414 (1985) (Fair Tax Act of 1985) [hereinafter Bradley-Gephardt bill]. *See also* S. 909, 99th Cong., 1st Sess. § 413 (1985) (SELF-Tax Plan Act of 1985) (same provision as § 414 of Bradley-Gephardt bill). For discussion of I.R.C. § 460 (1986), see Schneider & Solomon, *New Uniform Capitalization and Long-Term Contract Rules*, 65 J. TAX'N 424, 431–32 (1986); Taylor, *1986 Tax Reform Act: Accounting Provisions*, 27 TAX MGMT. (BNA) No. 25, at 328–30 (Dec. 8, 1986).

[6] *See* I.R.C. §§ 1291–1297, *added by* TRA 1986, *supra* note 4, § 1235(a). For legislative history, see SENATE REPORT, *supra* note 4, at 392–98; HOUSE REPORT, *supra* note 5, at 406–12; CONFERENCE REPORT, *supra* note 4, at II-640 to -645. *See also* BLUEBOOK,

Moreover, the Tax Reform Act of 1984 imposed an interest charge on shareholders of a Domestic International Sales Corporation (DISC) to compensate for tax deferral with respect to accumulated DISC income.[7] These developments may indicate a willingness on the part of Congress to consider an interest charge in other contexts as well.[8]

This Article will consider the desirability and feasibility of using an interest charge to compensate for delay in income reporting in various situations and will explore alternative ways of determining the proper interest charge.

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*supra* note 4, at 1021–33. A foreign corporation is a PFIC if at least 75% of its gross income is passive income or at least 50% of its assets produce passive income. I.R.C. § 1296(a) (1986). *See* BLUEBOOK, *supra* note 4, at 1024–26. Generally, a United States investor includes in income his share of PFIC earnings only when such earnings are realized by a distribution or sale of stock. (This assumes that the current inclusion rules of subpart F and the foreign personal holding company provisions are not applicable. *See* BLUEBOOK, *supra* note 4, at 1021, 1032–33.) The tax imposed on PFIC earnings attributable to a prior year is determined at a special rate and is subject to an interest charge. I.R.C. § 1291 (1986). In the case of a PFIC that is a qualified electing fund, the investor includes in income his share of PFIC earnings in the year that the earnings are derived by the PFIC. I.R.C. § 1293 (1986). Section 1295 of the Code requires a qualified electing fund to provide current earnings information to its United States investors. I.R.C. § 1295 (1986). An investor in such a fund may elect, however, to extend the time for paying the portion of his tax liability attributable to PFIC earnings until the earnings are distributed or realized by a sale. The extended tax bears interest. I.R.C. § 1294 (1986).

[7] *See* I.R.C. § 995(f), *added by* Tax Reform Act of 1984, Pub. L. No. 98-369, § 802(a), 98 Stat. 997, 997–99. *See* Prop. Treas. Reg. § 1.995(f)-1 (relating to interest charge); I.R.S. Announcement 86-44, 1986-14 I.R.B. 41 (availability of Form 8404 for determination of interest charge). *See also* I.R.C. §§ 667(a)(3), 668 (1986) (interest charge with respect to accumulation distributions by foreign trust). *See infra* note 153.

[8] Prior to the current legislative session, it was proposed that an interest charge be imposed in all cases in which the installment method is used. *See* JOINT COMMITTEE ON TAXATION, TAX REFORM PROPOSALS: ACCOUNTING ISSUES 22–23, 27 (JCS-39-85) (1985) [hereinafter JCT PAMPHLET]; Sheppard, *Ginsburg Discusses Taxing the Privilege of Tax Deferral in Installment Sales*, 27 TAX NOTES 457 (1985); Note, *Fairness and Tax Avoidance in the Taxation of Installment Sales*, 100 HARV. L. REV. 403, 403, 411–14. The Treasury rejected this idea "because of the increased complexity and taxpayer perception problems that such an approach would create." 1 U.S. DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 129 (1984) [hereinafter TREASURY I]. The Treasury argued that "[m]ost taxpayers would not readily comprehend why they should pay interest on the deferred taxes when the taxes are only paid as installment payments are received." *Id.* The latter argument was criticized by Ginsburg and by the author of the above Note. Sheppard, *supra* at 457; Note, *supra* note 8, at 413–14. *Cf.* Cain, *Installment Sales by Retailers: A Case for Repeal of Section 453(a) of the Internal Revenue Code*, 1978 WIS. L. REV. 1, 21 - 22 (proposing repeal of installment method for retailers and rejecting possibility that, in the event of repeal, cash-poor retailers be permitted to borrow with interest from the government). The author noted that, if the government lends to taxpayers at interest, tax return calculations would be more complicated, and the government would have to adjust the borrowing rates, with resulting uncertainty. She argued that government provision of loans is not necessary since borrowing from financial institutions is available to retail installment sellers. *Id.*

## II. Accrual Taxation and the Alternative of an Interest Charge

The economist Henry Simon has defined income as the sum of "(1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights" during the taxable year.[9] Under this definition, income should reflect changes in the value of a capital asset as they occur and the value of a right to receive payment for goods or services that has been earned by performance.

Under the federal income tax, many cases exist in which income is reported later than it would be under Simon's definition. For example, as a result of the use of the cash method of accounting,[10] deferred compensation of an executive, athlete, or entertainer,[11] and fees of a professional, are not included in taxable income until receipt. Profits of a manufacturer, retailer, or wholesaler from installment sales of goods may be deferred under the installment method[12] (except to the extent of the indebtedness of the taxpayer that is allocated to his installment obligations under the proportionate disallowance rule).[13] Sixty

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[9] H. Simon, Personal Income Taxation 50 (1938).

[10] Income from services generally may be reported under the cash method. *See* I.R.C. § 446(a) - (c) (1986); Treas. Reg. § 1.446-1(c)(2)(i) (1986). The 1986 legislation imposes an accrual requirement on service businesses conducted by C corporations or by partnerships having a C corporation as a partner, but exempts qualified professional service corporations (as well as businesses having gross receipts below a specified threshold). I.R.C. § 448, *added by* TRA 1986, *supra* note 4, § 801. The Treasury had proposed that an accrual requirement be imposed on all service businesses, unless gross receipts were below a specified threshold. 2 Treasury I, *supra* note 8, at 216; The President's Proposals to the Congress for Fairness, Growth and Simplicity 213 (May 30, 1985) [hereinafter Treasury II].

[11] *See* Rev. Rul. 60-31, 1960-1 C.B. 174; M. Chirelstein, Federal Income Taxation § 11.01(b), at 212 - 15 (4th ed. 1985) (under the cash method, taxation of non-qualified deferred compensation in the form of an unsecured promise of an employer is delayed until payment). This benefit is offset by a compensating tax burden on the employer, whose deduction is deferred under § 404(a) or § 404(d). I.R.C. § 404(a), (d) (1986). If the employer is tax-exempt, if it is taxed at a lower rate than the employee, or if it is eligible for special treatment of its investment income, however, some advantage still remains. *See* Halperin, *supra* note 3, at 523, 539 - 40.

[12] *See* I.R.C. § 453A(a)(1) (1986) (sales by dealers of personal property may be reported under the installment method if the sale is on the installment plan). An installment plan is a plan contemplating that sales will be paid for in two or more payments. Treas. Reg. § 1.453-2(b)(1) (1987). Under the 1986 legislation, the installment method may not be used with respect to sales made under a revolving credit plan or sales of marketable securities. *See* TRA 1986, *supra* note 4, § 812(a) (adding I.R.C. § 453(j)(1)–(2)). *See infra* note 28.

[13] *See* I.R.C. § 453C, *added by* TRA 1986, *supra* note 4, § 811(a). Under this rule, "a pro rata portion of the taxpayer's indebtedness is allocated to, and is treated as a payment on, the installment obligations of the taxpayer." H.R. Rep. No. 391, 100th Cong., 1st Sess. 1535 (October 26, 1987), *reprinted in* 1987 Stand. Fed. Tax Rep. (CCH) No. 45 (Nov. 2, 1987).

percent of the income of a contractor from a long-term contract may be deferred until the contract is completed.[14] Capital gains are not included in income until they are realized and recognized; inclusion of such gains may be delayed further under the installment method.[15] Finally, increases in the cash surrender value of a life insurance policy or deferred annuity contract are not included in income on a current basis.[16]

By investing in ways that permit tax deferral,[17] a taxpayer achieves a higher after-tax return on his investment than he could achieve on other investments that generate the same pretax rate of return.[18] This enhancement of after-tax return through tax deferral distorts economic behavior by encouraging investment in such tax-favored forms.[19] Moreover, inequities result because deferral is denied with respect to other forms of investment or with respect to income from wages received currently.[20]

Rules permitting income deferral also adversely affect the federal government's budget. If the government is to maintain

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[14] *See* I.R.C. § 460(a)(1)(B), *added by* TRA 1986, *supra* note 4, § 804(a) (percentage of completion method must be used with respect to 40%, or 100%, of items under long-term contract). A "long-term contract" is defined generally as a contract for the manufacture, building, installation or construction of property if such contract is not completed within the taxable year in which the contractor entered into the contract. I.R.C. § 460(f)(1) (1986). Under the completed contract method for reporting income from a long-term contract, inclusion of the gross contract price and deduction of the costs allocated to the contract are deferred until completion of the contract. *See* JCT PAMPHLET, *supra* note 8, at 45. For costs allocable to the contract, see I.R.C. § 460(c) (1986). *See generally* Taylor, *supra* note 5, at 328–30.

[15] *See* I.R.C. §§ 453(a), 453(b), 1001(a), 1001(c) (1986). For denial of use of installment method for sales of marketable securities, see *infra* note 28. The proportionate disallowance rule applies to some casual sales of real property, i.e., sales of real property used in the taxpayer's trade or business or held for the production of rental income but only if the sales price of the property exceeds $150,000; a disposition of personal use property by an individual or a disposition of certain farm property is excluded. *See* I.R.C. § 453C(e)(1)(A), (B) (1986).

[16] For a discussion proposing the end of such deferral, see 2 TREASURY I, *supra* note 8, at 258–61, 266–67.

[17] When a taxpayer accepts delayed payment for goods or services from a customer, the tax-favored investment takes the form of the customer's obligation to pay for the goods or services.

[18] *See* Cain, *supra* note 8, at 12–14, 20–21 (example involving installment sales).

[19] In some cases, however, it might be desirable to encourage certain forms of investment through tax deferral. For example, Congress has deliberately created a tax advantage for investments in qualified retirement plans, which are required to be "available to a broad group of employees," in order to "promote adequate retirement income for low and moderate wage earners." *See* Halperin, *supra* note 3, at 539.

[20] *See* 1 TREASURY I, *supra* note 8, at 163 ("tax deferral lowers the effective tax rate on the tax-preferred activity, distorts the allocation of investment across industries, and causes similarly situated taxpayers to be treated differently"). For a discussion of the possibility that market forces prevent tax preferences from causing inequity, see articles cited and summarized in Blum, *Rollover*, *supra* note 2, at 392 n.29.

the same level of expenditures that it would make if tax payments were not delayed, either the Treasury must increase its borrowings or Congress must increase current taxes (e.g., by raising tax rates). Increased borrowing by the Treasury may negatively affect the nation's economy, affecting interest rates, the trade deficit, and the accumulation of capital.[21]

Finally, the Treasury may be less likely to collect delayed tax payments than to collect current payments.[22] Deferring tax payments with respect to an investment until the taxpayer has cash receipts therefrom may improve the taxpayer's ability to make payment; however, deferring tax payments may increase the likelihood that an untrustworthy taxpayer will use the receipts for purposes other than paying taxes before the Internal Revenue Service asserts its claim thereto.[23]

The failure of Congress to eliminate rules permitting deferral, despite the disadvantages described above, stems from the perception of difficulties in implementing accrual taxation. The taxpayer may have difficulty raising cash to pay the tax with respect to accrued appreciation in an asset or with respect to income reflected in a right to receive future payment for goods

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[21] *See Hearings before Joint Economic Committee on Gramm-Rudman Budget Proposal*, 99th Cong., 1st Sess. 32–45 (1985) (statement of Franco Modigliani, Professor of Economics at the Massachusetts Institute of Technology). Additional adverse effects cited by Professor Modigliani include an increase in interest rates paid by debtor countries and increased unemployment in the European common market countries. *Id. See also* SENATE COMM. ON THE JUDICIARY, BALANCED BUDGET AMENDMENT PROPOSAL, S. REP. No. 163, 99th Cong., 1st Sess. 36–40 (1985) (high deficits have contributed to inflation, economic stagnation, low levels of capital formation, and weakening of trade position).

[22] Shakow makes this argument in rejecting Professor Vickrey's proposal for cumulative lifetime averaging of income through a system of interest-bearing tax liabilities. Shakow argues that, as in the case of tax deferral loans under present law, Vickrey's proposal would make the government a "willing lender to anyone who wished to borrow without providing meaningful credit control." Shakow, *supra* note 2, at 1164. Shakow notes that many taxpayers who obtain interest-free tax deferral loans by entering into tax shelter arrangements "ignore the implicit debt that they are carrying." *Id.* Shakow argues that "[i]f tax liabilities were accrued with explicit interest, so that a taxpayer's debt grew over time, we could expect taxpayers to lack the money to pay the debt in many more circumstances." *Id.* at 1170. Shakow concludes that it is desirable to limit situations in which tax payments with respect to accrued capital gains can be postponed. *Id.* For Vickrey's proposal, see Vickrey, *Tax Simplification through Cumulative Averaging*, 34 LAW & CONTEMP. PROBS. 736 (1969).

[23] If tax payments are due in a year before the taxpayer has cash receipts from the investment, the Internal Revenue Service will learn of a default by the taxpayer before the taxpayer receives the cash. The Internal Revenue Service will be able to assert a claim to the receipts that is superior to other claims, unless the taxpayer has already used the receipts as collateral for a loan. *See* Shakow, *supra* note 2, at 1170 n.228 (taxpayer may use capital asset, as to which tax liability is postponed, as explicit security for other loans, and secured creditor would have priority in bankruptcy).

or services. Moreover, valuing the asset or the right to receive payment may be difficult.[24]

These difficulties have generally been considered to preclude accrual taxation of capital gains.[25] These concerns (and some related ones) apparently motivated Congress in its recent rejection of a Treasury proposal to impose an accrual requirement on large professional firms.[26] Problems of liquidity[27] are the

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[24] For a discussion of difficulties of implementing accrual taxation of deferred compensation arrangements, see Halperin, *supra* note 3, at 541–42. He rejects accrual taxation in this context because of the valuation difficulties resulting from the contingent nature of some retirement benefits and because of the higher marginal rates that would result from bunching of income. Moreover, he suggests that there may be a lack of taxpayer comprehension and acceptance of accrual taxation of contingent benefits. He notes, however, that problems of liquidity could be avoided by requiring withholding by the employer (who could draw on his tax savings from an immediate deduction or on funds to be set aside for the employee). *Id.* As an alternative, Halperin proposes a special tax on the investment income of a nonqualified deferred compensation plan. *Id.* at 544–50. *See also* Shakow, *supra* note 2, at 1138–39 (discussing accrual taxation of defined benefit and defined contribution pension plans).

[25] *See* Andrews, *supra* note 1, at 1141–43, 1147. *See also* Shakow, *supra* note 2, at 1113 n.8, 1132–37, 1141–54 (valuation), 1167–76 (liquidity). Shakow argues that many capital assets should be subject to accrual taxation. He would, however, exclude some hard-to-value assets, such as stock of closely-held non-S corporations, owner-occupied housing, and consumer durables with purchase prices below $20,000. *Id.* at 1119, 1136, 1141, 1153–54. He argues that accrual taxation of the remaining assets would not result in very severe liquidity problems. He would permit taxpayers who could demonstrate such problems to make delayed tax payments with interest. *Id.* at 1167–76. Some have proposed that accrual treatment be extended solely to gains or losses with respect to publicly held stock. *See* Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 YALE L.J. 623 (1967); Note, *supra* note 2. A mark-to-market rule is currently applied to regulated futures contracts, foreign currency contracts, and certain options. *See* I.R.C. § 1256 (1986).

[26] *See supra* note 10. For criticism of this Treasury proposal by professionals and Congressional reaction, see Blum, *Should Professionals Accept "Accrual" Fate?*, 6 VA. TAX REV. 593, 596–98 nn.11–13 (1987) [hereinafter Blum, *"Accrual" Fate*]. Professionals argued that valuation of the right to receive fees would be difficult, particularly before billing, and that accrued amounts might be overstated because of failure to reflect the various uncertainties involved. They also argued that they would have difficulties raising cash to pay the tax on uncollected fees, particularly in the transition period. The concentration of income in the transition period might also affect the applicable marginal rates. Professionals argued that revising their accounting systems would be inconvenient and expensive and that coordinating accrual method tax accounting with cash method internal partnership accounting would be burdensome. Finally, they argued that the proposed exclusion of small businesses, which might be disproportionately burdened by an accrual requirement, would be discriminatory and would be a disincentive to growth. For assessment of these concerns, see *id.* at 630–68 (valuation), 668–97 (liquidity and transition), 697–707 (partnership accounting and exclusion of small businesses).

[27] *See* S. REP. No. 1000, 96th Cong., 2d Sess. 7 (1980), *reprinted in* 1980-2 C.B. 494, 497 (installment method "alleviates possible liquidity problems"); SENATE REPORT, *supra* note 4, at 123 ("[i]n general, the underlying reason for allowing the computing of gain on the installment method . . . is that the seller may be unable to pay the tax currently because no cash may be available until payments under the obligation are received").

For a discussion of early legislative history of the installment method, see Cain, *supra* note 8, at 2–10; Note, *supra* note 8, at 405. Both suggest that use of the installment method by merchants is no longer compelled by liquidity concerns in light of the apparent justification for permitting use of the installment method. This explanation was confirmed by Congressional action in 1986, limiting the use of that method in situations in which liquidity was thought not to be a concern.[28]

By contrast, valuation difficulties have been the apparent justification for permitting use of the completed contract method.[29] Prior to the completion of the contract, the contractor may have difficulty accurately determining the extent of his profit, if any.[30]

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availability of credit from financial institutions. *See* Cain, *supra* note 8, at 21–22 (loans available to retail installment sellers through assignment of consumer installment sales contracts); Note, *supra* note 8, at 405–06 (loans available to buyers). However, the author of the above Note argues that immediate tax payments might create hardship for an installment seller in the case of a casual sale or a sale of real estate "for which commercial credit is less readily available." *Id.* at 405. He argues that, if the installment method were repealed, cash-poor sellers of high-risk properties, such as small businesses or undeveloped property, might be forced to accept "the highest available lump-sum offer" or might be unable to sell the property at all. *Id.* at 409 n.34.

[28] Congress denied use of the installment method for sales of stock and securities traded on an established securities market. I.R.C. § 453(j)(2), *added by* TRA 1986, *supra* note 4, § 812(a). *See* SENATE REPORT, *supra* note 4, at 124 ("since the taxpayer can easily sell such property for cash in the public market, the committee believes that such property does not present the same liquidity problems that the installment method is designed to alleviate"). Congress also generally denied use of the installment method, under the proportionate disallowance rule, to the extent of the indebtedness of the taxpayer that is allocable, on a pro rata basis, to his installment obligations. *See* I.R.C. § 453C (1986); *see also supra* note 13. The committee report explains that use of the installment method is not appropriate "to the extent that the taxpayer has been able to receive cash from borrowings related to its installment obligations." SENATE REPORT, *supra* note 4, at 123. *See generally* JCT PAMPHLET, *supra* note 8, at 22–23 (rationale for Treasury proposal dealing with pledges of installment obligations).

[29] For a description of this method, see *supra* note 14.

[30] Rev. Rul. 70-67, 1970-1 C.B. 117, offers the following justification of the completed contract method:

> One of the reasons why permission to report on a completed contract basis is given . . . is the fact that there are changes in the price of articles to be used, losses and increased costs due to strikes, weather, etc., penalties for delay and unexpected difficulties in laying foundations which makes [sic] it impossible for any construction contractor, no matter how carefully he may estimate, to tell with any certainty whether he has derived a gain or sustained a loss until a particular contract is completed.

*See also* Zakupowsky, *The Completed Contract Method*, 33 TAX NOTES 396 (1986) (use of completed contract method by contractors is intended to achieve certainty by avoiding "subjective determinations" made in using percentage of completion method). *See also infra* note 182.

Financial accounting standards have generally favored use of the percentage of completion method, rather than the completed contract method, unless "lack of dependable estimates or inherent hazards cause forecasts to be doubtful." LONG-TERM CONSTRUCTION-TYPE CONTRACTS, Accounting Research Bulletin No. 95, (Am. Inst. of Certified Pub. Accountants 1955). *See* JCT PAMPHLET, *supra* note 8, at 46.

Liquidity is apparently less of a concern in that progress payments may often be received before completion of the contract. *See id.* at 43 ("[i]t is common for businesses performing under long-term contracts to receive progress payments over the life of the contract"). The Joint Committee notes that, in some cases, progress payments represent prepayments for products to be delivered or services to be performed in a future taxable year. *Id.* In 1982, the Treasury made a legislative proposal that taxpayers not using the

Problems of liquidity (augmented in some cases by problems of valuation) were the reason for Congress' decision in 1986 to permit a United States investor in a PFIC to delay reporting his share of the PFIC's earnings until received by distribution or sale of stock.[31]

This Article will not assess whether these concerns about difficulties in implementing accrual taxation justify current rules permitting income deferral.[32] Instead, it will focus on the alternative of permitting income deferral but requiring compensation therefor through an interest charge. A further alternative to be considered is that of imposing accrual rules but compensating for mistaken estimates of income by means of an interest charge or credit, determined by hindsight. These alternatives will be evaluated in comparison with the current treatment and accrual treatment.

The desirability of an interest charge depends upon the extent to which it can achieve the following goals: (1) reducing or eliminating the inequity, distortion of behavior, and government budgetary problems resulting from income deferral; (2) avoiding liquidity and valuation problems and other administrative difficulties involved in implementing accrual taxation; and (3) avoiding administrative or other difficulties unique to implementation of an interest charge. The extent to which these goals can be achieved may vary in different situations and may depend upon the design of the interest charge.

The next part of this Article will examine how an interest charge should be designed, in various contexts, to best achieve these potentially conflicting goals. It considers first the interest

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percentage of completion method be required to recognize income from long-term contracts when progress payments were received to the extent that such payments exceed accumulated costs. *See id.* at 47. *But cf.* Zakupowsky, *supra*, at 397 ("costs expended [by contractors] normally *exceed* progress payments") (emphasis in original).

[31] *See* SENATE REPORT, *supra* note 4, at 393–94 (in some cases United States investors in PFICs "do not have ongoing access to the PFICs' records relating to their earnings and profits, do not have control sufficient to compel dividend distributions, or do not have sufficient liquidity to meet a current tax liability before they directly realize income from their PFIC investment"); CONFERENCE REPORT, *supra* note 4, at II-643 to -644 ("even though U.S. investors may receive adequate income information from a PFIC, the U.S. investors may not have sufficient ownership in the PFIC to compel distributions"). For imposition of interest charge with respect to United States investors in a PFIC, see *supra* note 6.

[32] *See* Blum, *"Accrual" Fate*, *supra* note 26, for an argument that, under a properly designed system for accrual taxation of professional fees, the concerns voiced by professionals would not be so serious as to outweigh the benefits of greater accuracy in income measurement.

rate to be employed and then the time and method of determining and paying the interest charge.

## III. Choice of Interest Rate[33]

### A. *Taxpayer's Return on Investment of Deferred Tax*

#### 1. Determining the Taxpayer's Rate of Return

A taxpayer permitted to defer reporting of income can invest the amount of the resulting deferred tax for the period of deferral. However, if the taxpayer is required to pay over to the Treasury the amount that he earns from investment of the deferred tax, he is no better off than other taxpayers not accorded deferral treatment. Therefore, requiring such a payment to the Treasury eliminates the inequity resulting from deferral and removes the incentive to invest in forms that permit deferral.[34]

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[33] A number of commentators have discussed the appropriate interest rate for a deferral charge with respect to the tax on capital gains. Wetzler states simply that the rate should be "based on the actual interest rates that prevailed" during the asset's holding period. Wetzler, *supra* note 2, at 121. Brinner recommends use of "some average federal government borrowing cost over the holding period of the gain" since the tax deferral loan should be viewed as virtually default-free. Brinner, *Comments*, *supra* note 2, at 156. Bradford and the Meade Commission Report suggest that the interest rate should be set by reference to the return that a taxpayer receives on investments. BLUEPRINTS, *supra* note 2, at 74; MEADE COMMISSION REPORT, *supra* note 2, at 132. Shakow discusses the deferral charge in two different contexts and looks to the rate of return for the government in one case and the borrowing rate of the taxpayer in the other. Shakow, *supra* note 2, at 1122, 1176. *See infra* notes 56 & 65.

The Joint Committee suggests that a deferral charge with respect to use of the installment method could be determined "either at the rate normally charged for tax underpayments or at the rate of interest that the installment obligation bears." JCT PAMPHLET, *supra* note 8, at 27. Another author who discusses a deferral charge with respect to use of the installment method suggests using the applicable federal rate under I.R.C. § 1274(d) (1986), apparently because of its relationship (although it is lower) to the taxpayer's borrowing rate. Note, *supra* note 8, at 411 n.46, 412–13. Under the Bradley-Gephardt bill, the interest charge with respect to use of the completed contract method is determined by reference to the interest rate charged on underpayments of tax. Bradley-Gephardt bill, *supra* note 5, § 414(a). Under the yield-based approach, the pre-tax yield of the deferred payment obligation is used to measure the value of tax deferral. *See supra* note 3.

[34] *See* BLUEPRINTS, *supra* note 2, at 74; MEADE COMMISSION REPORT, *supra* note 2, at 132. Bradford argues that "to eliminate economic inefficiency," the interest rate for a deferral charge on capital gains should be "the individual taxpayer's rate of return on his investments." On the other hand, he notes that "because it is impossible to administer a program based on each investor's marginal rate of return," a single interest rate would have to be used for all taxpayers. BLUEPRINTS, *supra* note 2, at 74. The Meade Commission Report states that the interest rate for a deferral charge on capital gains "should be a post-tax interest rate (to reflect the net rate of return which the taxpayer could have obtained on the postponed payment of tax)." It suggests use of the interest rate

The amount earned from investment of the deferred tax might be determined by reference to the return received by the taxpayer during the period of deferral from the investment accorded deferral treatment.[35] In many cases, however, it might be difficult to identify the return received on that investment (even after the investment is terminated). The total amount received on termination of the investment may be known, but not the amount invested.[36] For example, if property or services are paid for on a delayed basis without an explicit interest charge and the value of the goods or services is not known, the portion of the delayed payment representing interest cannot be determined, except by reference to a risk-free market rate, such as the rate paid on government borrowings.[37] A risk-free rate may

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"on government securities of, say, five years' maturity," reduced by a specified tax rate. MEADE COMMISSION REPORT, *supra* note 2, at 132. *See also* Vickrey, *supra* note 22, at 736, 738, 741 (under cumulative averaging proposal, pursuant to which tax payments are treated as interest-bearing deposits in a tax guarantee account, "[i]nvestment in early tax payments is made just as profitable as outside investment of funds obtained by deferring taxes"); M. DAVID, ALTERNATIVE APPROACHES TO CAPITAL GAINS TAXATION 186–88, 217 (1968) (under cumulative averaging proposal, interest credited on taxes should be at the rate on prime commercial paper or the mean rate of return despite frequent creation of small incentive to early realization; any positive rate would improve upon the current situation).

[35] *See* JCT PAMPHI T, *supra* note 8, at 27 (deferral charge with respect to installment method would be determined at the "rate of interest that the installment obligation bears"). *See also* Halperin, *supra* note 3, at 532 (underpayment of tax can be rectified by payment of interest at the rate the taxpayer "earns in the transaction"). For example, if a taxpayer takes a $100 deduction for an amount estimated to be payable in the future, "any advantage from an erroneous estimate can be eliminated if the estimated amount ($100) is kept separate and any unused sum, together with interest thereon, is included in income when it is no longer needed." *Id.* at 532. *See also* Land, *supra* note 3 at 284–85 (under yield-based approach, deferred taxes are assumed to be invested at the pre-tax yield on the investment).

[36] In the case of an appreciated capital asset that is not readily marketable, even though the initial investment and the sales price are known, it may be difficult to identify the portion of the total return allocable to each year in the holding period. *See infra* text accompanying notes 196–206.

[37] *Cf.* I.R.C. § 1274(b)(2)(B) (1986) (identifying implicit interest with respect to certain property sales by reference to the applicable federal rate, compounded semiannually); *id.* § 467(a)(2),(e)(4) (1986) (identifying implicit interest with respect to certain service contracts by reference to 110% of the applicable federal rate). The applicable federal rate is based upon the average market yield on outstanding marketable obligations of the United States with remaining periods to maturity similar to those of the debt instruments at issue. *Id.* § 1274(d). *See* Halperin, *supra* note 3, at 516 n.36 (full imputation can be accomplished without valuing goods or services "by imputing a market rate of interest and then attributing the residual payments to the value of goods or services"). *See also* Land, *supra* note 3, at 286, 295–96 (in applying the yield-based approach to a contingent obligation not issued for cash or readily valued property, the pre-tax yield is deemed to equal a market risk-free interest rate; this is based upon the assumption that the contingency relates to the issue price, and not to the yield, of the obligation). *See infra* note 189.

not be appropriate, however, because the taxpayer may receive a premium to compensate for risk-bearing.[38]

Moreover, the deferred tax cannot necessarily be assumed to have been invested in the asset accorded deferral treatment, any more than in other assets of the taxpayer. If the tax were payable on a current basis, the taxpayer might have paid it by withdrawing funds from other sources, particularly if those funds were earning a lower rate of return.[39] It may be even more difficult to determine the average or marginal[40] rate of return that the taxpayer receives on his investments during the period of deferral than it is to determine the rate of return on the particular investment accorded deferral.

### 2. Use of Uniform Rate

Thus, in order for an interest charge to be administrable, a uniform interest rate must be specified for all taxpayers.[41] This specification is necessary despite the fact that the rate of return

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[38] If there is a possibility that the customer will default, the amount charged by the taxpayer may include a default premium and a risk premium. The default premium insures that the expected return is no less than the return on a risk-free investment. The risk premium is an additional amount to compensate for risk-bearing. *See* W. SHARPE, INVESTMENTS 308–15 (1981). *See* Land, *supra* note 3, at 241–42, 295 (applicable federal rate fails to reflect "risk premium" included in interest rates paid by private issuer). Land notes that the risk premium depends upon "the issuer's financial condition, the priority of the obligation . . . and the nature of any assets securing the obligation." *Id.* at 242. In the event of default, however, the taxpayer's return from a particular transaction will be less than the market risk-free rate of return.

[39] *See* Folsom, *Neutral Capital Gains Taxation Under Inflation and Tax Deferral*, 31 NAT'L TAX J. 401 (1979) (challenging assumption that taxpayer required to pay capital gains taxes on accrual basis would always "reduce his investment in each asset by whatever amount was necessary to pay that same asset's taxes"). He suggests that the ideal interest rate for the deferral charge is the taxpayer's "own long-run overall marginal opportunity cost of capital." *Id.* at 402. In fact, the taxpayer might not have amounts invested in the activity during the entire period of deferral. For example, a contractor using the completed contract method may have received progress payments fully reimbursing him for costs incurred in performing the contract. *See supra* note 30. *See* Land, *supra* note 3, at 290–92 (unrealistic to assume that interim payments received on contingent obligation can be reinvested "at the same yield as that earned on the obligation").

[40] *See* BLUEPRINTS, *supra* note 2, at 74 (interest charge ideally should reflect taxpayer's "marginal rate of return"). *See supra* note 34.

[41] *See* BLUEPRINTS, *supra* note 2, at 74 (discussed *supra* note 34). *See also* Warren, *supra* note 2, at 318–19 ("no administratively feasible system [for choosing interest rate or rates] could hope to offset the actual benefits of deferral to taxpayers experiencing different rates of return on their deferred tax liabilities").

on investment varies among taxpayers so that any uniform rate will be more appropriate for some taxpayers than for others.[42]

The uniform rate might be set to equal the average return on investments for all taxpayers. This would result in overpayment of interest by taxpayers earning relatively low rates of return on their investments and underpayment by those earning higher rates. If variance from the average rate of return on investments were sufficiently great and sufficiently common among taxpayers, the resulting overpayment of interest by some taxpayers might be considered unacceptable.

An alternative would be to set the interest rate below the average rate of return on investments to reduce the likelihood of interest overpayment. Under present law, the rate of interest is, in effect, set at zero. This effective rate of zero avoids overpayment of interest by any taxpayer. The cost of having a zero rate, however, is underpayment by all taxpayers. Setting the interest rate at the rate paid on federal borrowings (i.e., the "federal rate" specified in section 1274(d) of the Code) would be preferable.[43] Since most taxpayers can achieve a rate of return on their investments at least as great as this rate (or at least do not fall short by a large amount),[44] use of this rate would result in only a small amount of overpayment, restricted to a few taxpayers. The amount of underpayment would be much less than under present law.

Nevertheless, a taxpayer's return from investing the deferred tax may fall below the federal rate. This result could occur if a risky investment turned out poorly. If the federal borrowing rate is used to determine the interest charge, the sum of the tax and interest charge on disposition of an investment might in some cases be greater than the proceeds of sale.[45] This result might

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[42] One taxpayer may receive a higher rate of return on his investments than another because, among other reasons, he has more sophisticated investment advice, his returns include rewards for bearing greater risk, he has a sufficiently large portfolio to permit diversification, or he has developed his own business opportunities.

[43] I.R.C. § 1274(d) (1986). *See supra* note 37.

[44] *See* Halperin, *supra* note 3, at 532–33 ("[o]n average, the rate of return in the private sector should exceed the Treasury's cost of funds").

[45] Assume that an asset purchased by the taxpayer for $1 increases in value to $101 after one year; it remains at the same value for the next 20 years after which it is sold for $101. Assume further that the taxpayer has no other investments and that the tax rate is 28%. The tax on the increase in value in the first year ($28) may be seen as invested in the asset, which generates no return over the next 20 years. If the interest charge is imposed at an after-tax rate of 7%, compounded annually, the interest charge owed at the end of the period is $80.35. This is in excess of the after-tax sale proceeds

pose a hardship to the taxpayer and discourage investment in risky assets. On the other hand, it might not be unreasonable to expect a taxpayer to liquidate a risky asset if its value does not keep pace with his tax liability and accrued interest with respect thereto.

If the interest rate paid on federal obligations is to be used, reference should be made to federal obligations with periods to maturity (at the time that deferral begins) equal to the expected period of deferral. For example, under section 453C(e)(4) of the Code (providing an interest charge with respect to certain installment sales), the interest rate used is the applicable federal rate—that is, the rate in effect at the time of the sale on federal obligations with a period to maturity similar to the term of the installment obligation.[46] If the expected period of deferral is indefinite,[47] reference should be made to the interest rates on short-term federal obligations.[48]

If the interest charge is imposed annually on the aggregate amount of tax deferral loans outstanding during the year (without identifying each loan individually), however, the interest rate cannot be determined with reference to the expected period of deferral. The most appropriate rate might then be the rate on short-term federal obligations for each year, as if the aggregate amount of the deferred tax were invested in an adjustable rate debt instrument.

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of $73. *See* Shakow, *supra* note 2, at 1170 n.228 ("increased value [of capital asset] may not cover the interest obligation that is accruing").

[46] *See* I.R.C. § 453C(e)(4)(B) (1986). *See also id.* § 1274(d)(1)(A) (1986) (applicable federal rate for short-term, mid-term, and long-term debt instruments).

[47] In some cases, the tax on income from a particular transaction is deferred for only a single taxable year but, since similar transactions occur repeatedly, the investment of the deferred tax may, in effect, continue indefinitely. For example, a cash method professional who receives fees one year after services are performed defers payment of the tax with respect to each fee for one taxable year. However, if the amount of year-end net receivables does not decline from year to year, the net amount of deferred tax also does not decline; whenever the amount of year-end net receivables increases, the net amount of deferred tax also increases. The professional may be viewed as receiving a series of loans from the Treasury with long (but indefinite) terms, each originating when growth in year-end receivables occurs. However, it is not feasible to determine the appropriate interest rate on this basis. Instead, the interest rate should be based upon the period of deferral of the tax on individual fees.

[48] *See* M. DAVID, *supra* note 34, at 188 (short-term rate should be credited on taxes under cumulative averaging proposal since taxpater could end deferral of gain at any time). Since the taxpayer would not be certain when his tax deferral loan would come due, he could be expected to invest in a short-term obligation so that funds would be available on short notice. Perhaps this is the rationale for use of the federal short-term rate (with adjustments) to determine the interest charge under I.R.C. §§ 460(b), 1291(c) (1986). *See supra* notes 5 & 6.

### 3. Allowance for Taxes

The interest rate used to determine the interest charge should be an after-tax rate, since the objective is for the government to recover from the taxpayer the return received from investing the deferred tax. That return would generally be reduced by current taxes (or, if not, the deferral of tax might be compensated for by an interest charge). The tax rate used to establish the after-tax interest rate should be the taxpayer's tax rate applicable to the return on the investment of the deferred tax (stacked on top of his other income) for each year.[49] This tax rate would be cumbersome for the taxpayer to determine.[50]

The same effect could be achieved by permitting the taxpayer to deduct the interest charge each year as it accrues. Thus, the interest should not be classified as personal interest, for which no deduction is allowed.[51] If the interest charge is not determined until a later year, deduction of the interest charge in each year that it accrues would require recomputation of the tax of one or more prior years. To avoid these complications, section 453C(e)(4) of the Code provides for the interest charge with respect to use of the installment method by certain taxpayers to be deducted at the time that it is determined (i.e., in each year that an installment is received),[52] even though the interest

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[49] *See* MEADE COMMISSION REPORT, *supra* note 2, at 132 (interest rate for deferral charge on capital gains should be an after-tax rate, "to reflect the net rate of return which the taxpayer could have obtained on the postponed" tax payment).

[50] *See id.* ("hopelessly complex to allow the interest factor to reflect the taxpayer's own tax rate (formally, his tax rates in the years when the gains were accruing)").

[51] For a discussion of disallowance of personal interest, see *infra* note 59. Characterization of the interest charge with respect to tax on deferred receipts as personal interest is inappropriate since the tax deferral loan permits the taxpayer to continue his investment in the deferred receipts. For deduction of interest charge, see I.R.C. § 453C(e)(4)(C) (1986) (amount of interest charge payable with respect to installment received during taxable year "shall be taken into account in computing the amount of any deduction allowable to the taxpayer for interest paid or accrued during such taxable year"). It is not clear whether this language would preclude the I.R.S. from denying a deduction of the interest charge on the basis that the interest is personal interest. *Cf.* Prop. Treas. Reg. § 1.995(f)-1(j), 52 Fed. Reg. 3271 (1987) (interest charge on DISC-related deferred tax liability is treated for all purposes of the Code in the same manner as interest on an underpayment of tax, and thus it may be deducted from gross income only to the extent that interest on an underpayment of tax would be deductible "and subject to all applicable limitations on the deduction for interest"). Section 460(b)(3) of the Code does not specify whether the interest charge is deductible or the interest credit is includable in income. I.R.C. § 460(b)(3) (1986). Since these amounts are referred to as "interest," the most likely inference is that they are intended to be so treated for purposes of determining income and deductions. *See also* I.R.C. §§ 1291(c), 1294 (1986) (deductibility not addressed).

[52] I.R.C. § 453C(e)(4) (1986). *See supra* note 51.

charge may have accrued over many prior years (beginning with the year in which the installment sale was made). A delayed deduction is less accurate than a current deduction[53] because (1) a delay will make the deduction less valuable, and (2) the tax rate applicable in the year of the deduction may differ from the rates applicable in the years that the interest charge accrued.

An alternative to deduction of the interest charge is the use of an assumed tax rate to determine an after-tax rate of interest. This assumed tax rate might either be a uniform rate established by the Treasury for each year or the tax rate applicable to the deferred income when recognized.[54] Any assumed rate, of course, would be inaccurate to the extent that a taxpayer's marginal rate for any year in which an interest charge accrued differed from the assumed tax rate for that year. To avoid any disadvantage to taxpayers, the assumed tax rate for each year could be set at the highest marginal rate for that year.[55]

### B. *Taxpayer's Interest Rate for Borrowing to Pay Tax*

#### 1. In General

Some have suggested that the rate of interest used to compute the interest charge should be the rate of interest that the taxpayer would pay if he borrowed from commercial sources in

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[53] *See* Wetzler, *supra* note 2, at 153 (more accurate to use after-tax interest factor than to deduct interest charge when capital gain is realized). This assumes that the tax on the return from investment of the deferred tax would not also have been deferred or that any such deferral would be compensated for by an interest charge.

[54] For use of uniform tax rate, see Wetzler, *supra* note 2, at 152–53; MEADE COMMISSION REPORT, *supra* note 2, at 132 (use of tax rate "equal either to the basic rate or to some arbitrary rate, say 50 per cent"); Brinner & Munnell, *supra* note 2, at 16. *See also* Bradley-Gephardt bill, *supra* note 5, § 414(a) (interest charge with respect to use of completed contract method may be computed under the "simplified" method or "exact" method). The interest rate used under the exact method is the rate of interest on tax underpayments or overpayments, while the interest rate used under the simplified method is 70% of the rate of interest on tax underpayments or overpayments. The interest rate under the simplified method is apparently intended to be an after-tax rate. Under the simplified method, the interest charge is not identified separately from the tax on the deferred income; thus, deduction of the interest charge is not feasible. *See infra* notes 233–36 and accompanying text. *Cf.* Land, *supra* note 3, at 284–85, 293 (value of tax deferral determined under yield-based approach by reference to tax rate for year in which deferred payment is received).

[55] *See* Brinner & Munnell, *supra* note 2, at 16 (the higher the tax rate, the lower the interest factor for capital gains deferral charge; "probably advisable" to use the top tax rate for all taxpayers; "[t]he slight resultant tax break given to lower-income investors would stimulate their return to the market and partially compensate for other tax shelters whose values rise with one's tax bracket").

order to pay tax currently.[56] The Treasury's acceptance of a delayed tax payment is viewed as a substitute for a loan from private sources (rather than as a co-investment by the Treasury). The taxpayer is no worse off paying a commercial rate to the Treasury than paying such a rate to a private lender.

The private borrowing rate would vary from taxpayer to taxpayer, however, depending on creditworthiness and on the property offered as collateral. It would not be practical for each taxpayer to determine his own rate. Private borrowing rates of taxpayers would, in nearly all cases, be in excess of the federal borrowing rate because of the greater risk of default and the fact that the loans would generally be obtained from retail lending institutions, such as banks and finance companies.[57] A taxpayer's private borrowing rate might also exceed his rate of return on investments. A uniform rate, if it is not to be less than taxpayers' private borrowing rate, should be somewhat more than the applicable federal rate.

Setting the interest rate for the deferral charge at a private borrowing rate seems inappropriate (at least in cases where accrual taxation is not feasible), because the taxpayer is forced either to accept a loan of the deferred tax from the Treasury with interest at the rate specified or to forego entirely investment

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[56] A recent Note discussing the possibility of an interest charge with respect to use of the installment method proposes that the interest rate used be the applicable federal rate, because of its relationship to the taxpayer's borrowing rate. Note, *supra* note 8, at 413. The author states that the "seller's loan from the government would therefore resemble as closely as possible a commercial loan." *Id.* The author also states that imposing the interest charge "would create no special hardship" but "would merely put the seller in the same position she would have been in had she obtained commercial financing." *Id.* at 411. The author notes that the applicable federal rate is "lower than commercially obtainable rates of interest" so that the taxpayer "continues to benefit to the extent of this difference." *Id.* at 411 n.46, 412–13. *See* Helliwell, *supra* note 2, at 315–16 (suggesting use of "fixed rate approximating the marginal borrowing rate of the average private asset holder"). *Cf.* Brinner, *Comments*, *supra* note 2, at 156 (discussed *infra* note 57).

*See also* Shakow, *supra* note 2, at 1176. Shakow proposes that capital assets susceptible of valuation be subject to accrual taxation. Taxpayers with demonstrable liquidity problems could arrange for postponed tax payments with interest. He suggests that "[t]o discourage persons from borrowing from the government at rates that might well be unavailable to them in the private debt market, the interest rate should be set at a level that would prove unattractive to most taxpayers." *Id.*

[57] *See supra* note 38. It has been argued that use of the risk-free federal rate would, nevertheless, be appropriate. *See* Brinner, *Comments*, *supra* note 2, at 156 ("[b]ecause of the enforcement powers of the federal government, the taxpayer could not default," and thus loans from the government can be regarded "as free of the risk of default"; thus, the interest charge should be based upon "some average federal government borrowing cost"). This argument, however, seems to overstate the government's success in collecting taxes. In addition, collection of taxes entails significant administrative costs, for which a private lender would require compensation.

in the asset accorded deferral. If the taxpayer could be given the option of paying the tax currently, he might not find it necessary to borrow from private sources for this purpose. He might have liquid assets, or be able to liquidate a portion of his nonliquid assets, in an amount sufficient to pay a current tax. This would be less expensive than borrowing if the borrowing rate exceeded his return on such assets. Thus, setting the interest charge at a private borrowing rate may make the taxpayer's tax burden heavier than it would be if accrual taxation were feasible.

### 2. No Valuation Difficulties

Setting the interest charge at the private borrowing rate may be more defensible in cases where there are no valuation difficulties that preclude determination of a current tax. This would be true with respect to gains from installment sales and capital gains with respect to marketable assets. In those cases, a taxpayer could be given the option of paying tax on an accrual basis in lieu of paying the interest charge.

Assuming that the private borrowing rate exceeds the rate of return on his investments, a taxpayer who had sufficient liquid or near-liquid assets to pay the tax would have an incentive to do so, rather than to borrow the tax from the Treasury at the private borrowing rate. Tax deferral would thus be limited generally to those taxpayers who, in fact, face liquidity problems.

If taxpayers accorded deferral benefits are generally in a position to borrow from commercial sources to pay a current tax, the interest rate might even be set somewhat higher than the private borrowing rate.[58] A higher rate would discourage cash-poor taxpayers from borrowing from the Treasury when they are able to borrow from commercial sources.[59] Nevertheless,

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[58] *See* Shakow, *supra* note 2, at 1176 (discussed *supra* note 56). Shakow assumes that taxpayers could borrow to pay tax on accrued capital gains with respect to assets not difficult to value. *See id.* ("[a]fter all, they could borrow from someone other than the government to pay their taxes"). At another point, however, Shakow notes that taxpayers accorded tax deferral loans are sometimes not good credit risks. *See id.* at 1169–70 (discussed *supra* note 22). *See also supra* note 27 (taxpayers making casual installment sales of high-risk assets may have difficulty borrowing to pay the tax).

[59] This result rests on the assumption that if the interest charge payable to the Treasury is deductible or is set at an after-tax rate, a deduction is also permitted for interest on private borrowing needed to pay the tax currently. Under TRA 1986, personal interest is not deductible unless it is qualified residence interest. I.R.C. § 163(h)(1), (2)(C), (3) (1986). Personal interest generally includes interest on tax deficiencies, *see* CONFERENCE

borrowing from the Treasury might be favored because of its greater convenience.[60]

Even in these limited circumstances, however, computing the interest charge at or above the private borrowing rate has some disadvantages. Taxpayers who could not raise cash in any other way would be forced to borrow (from the Treasury or commercial sources) at the private borrowing rate to pay the tax. These taxpayers would accumulate a smaller after-tax amount than taxpayers who make alternative investments yielding current receipts sufficient to pay a current tax. This disparity would be inequitable to the taxpayer paying the interest charge.[61] Moreover, it would discourage investment in assets subject to the interest charge.[62]

Avoiding this result may be one of the objectives of permitting income deferral in situations in which a taxpayer's receipts are deferred but valuation of such receipts is not difficult. Congress might recognize that some of these taxpayers (such as retailers making installment sales or holders of marketable securities) are

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REPORT, *supra* note 4, at II-154, and apparently also includes interest on borrowings obtained to pay taxes. It would seem more appropriate, however, to allow a deduction for interest on borrowings to pay current tax with respect to deferred receipts. The borrowing permits the taxpayer to continue his investment in the deferred receipts; thus, it should be viewed as business or investment interest, rather than as personal interest. If the deduction is permitted, the taxpayer, after paying interest on the loan and receiving the deferred receipts, would accumulate the same amount after-tax as another taxpayer whose receipts are current and who invests the after-tax receipts at the same pre-tax rate of return.

[60] *See* M. DAVID, *supra* note 34, at 188 (under cumulative average proposal, government loan might offer "greater convenience" and may be available on more favorable terms for risky investment). A more effective way to assure that the Treasury will be only the lender of last resort is to condition tax deferral on a showing that the taxpayer lacks liquid or marketable assets and is unable to borrow from commercial sources. This approach has the disadvantage, however, of imposing a greater administrative burden on the Treasury.

[61] The taxpayer would, however, be no worse off than if Congress had imposed an accrual requirement (without the alternative of an interest charge) even though the taxpayer's receipts are deferred. This is the treatment accorded investors in bonds with original issue discount, see I.R.C. § 1272(a) (1986), and C corporations that are required to report service income on an accrual basis. *See* I.R.C. § 448(a) (1986). These taxpayers are forced to borrow if they do not have liquid assets sufficient to pay a current tax. Similarly, installment sellers denied use of the installment method because of borrowings, *see* I.R.C. § 453C (1986), may be required to obtain additional loans in order to pay a current tax on installment gains; the proceeds of the borrowing that results in the current tax may have been used for other purposes. *See infra* note 317.

[62] Reducing or eliminating investment in assets subject to the deferral charge might not be a desirable alternative for the taxpayer, however, if the asset is important to the conduct of the taxpayer's business. For example, businesses selling goods or services might have difficulty competing if they failed to accept delayed payment from customers (thus, in effect, investing in customer receivables).

able to borrow to pay a current tax.[63] Congress might conclude that forcing such taxpayers to borrow is unfair because the borrowing rate would exceed the rate of return from investing the tax.[64]

### C. *Borrowing Costs of the Treasury*

An interest charge is intended, at least in part, to compensate the Treasury for the effect of delayed tax receipts. Because of the current budget deficit, delayed tax receipts operate to increase the Treasury's borrowings (or to reduce expenditures) rather than to reduce the Treasury's savings.[65] The Treasury's costs from increased borrowings would include not only interest paid by the Treasury on its obligations, but also the administrative costs associated with borrowing. The Treasury's borrowing costs are reduced by tax payments made by lenders with respect to interest received from the Treasury.[66]

If the applicable federal rate is used to determine the interest charge, the Treasury would be reimbursed for its interest expense but not for its other costs of borrowing. Defaults by taxpayers in paying the interest charge and tax would reduce the reimbursement to the Treasury.[67] Reimbursement would also fall short to the extent that the average tax rate of taxpayers who deduct the interest charge (or the uniform tax rate used to establish an after-tax interest rate for the interest charge) is higher than the average tax rate of lenders to the Treasury who finance the deferred tax receipts.

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[63] *See supra* notes 8, 27 & 58. By contrast, borrowing to pay current tax may be difficult for a taxpayer making a casual installment sale of an interest in a closely held business.

[64] *See* Land, *supra* note 3, at 288 (accrual treatment is inaccurate to the extent that a holder of an obligation to make deferred payment incurs borrowing costs to pay tax that are in excess of the yield on the obligation). If this is of concern to Congress, however, it is not clear why Congress has imposed a current tax on some categories of taxpayers whose receipts are deferred. *See supra* note 61.

[65] *But cf.* Shakow, *supra* note 2, at 1122–23 (deferral charge for capital gains not susceptible to accrual taxation should be designed "to reflect the interest the government could have earned on an immediate tax on gains when they occurred").

[66] *See* Halperin, *supra* note 3, at 532 n.98 ("since interest is taxable, the net cost of borrowing may be said to be the after-tax rate").

[67] But it is not known whether such defaults would be any greater, in present value, than the defaults that would occur under accrual taxation. *See supra* text accompanying notes 22–23.

### D. *Interest Credit Where Income Accelerated*

Similar considerations apply if an interest credit is used to compensate a taxpayer for acceleration in the reporting of income (i.e., the Treasury is required to pay interest on a loan made to it by the taxpayer).[68] Since the taxpayer whose income is accelerated loses, for the period of acceleration, the opportunity to invest the accelerated tax, he should be compensated by being paid interest at the rate that he would have earned on such investment.[69] If, however, the taxpayer must borrow to pay the accelerated tax and his borrowing rate is higher than his return on investments, he would be worse off than other taxpayers not required to borrow to pay tax unless the interest credit is determined by reference to his borrowing rate. Since a taxpayer's return on investments will often exceed the applicable federal rate and since his borrowing rate will nearly always exceed the applicable federal rate, the rate for the interest credit must be higher than the applicable federal rate to insure full compensation in all cases.

Since the income from investing the accelerated tax would have been subject to tax (and generally on a current basis), the interest credit also should be subject to tax. Including the interest credit in income as it accrues may not be feasible, however, if the interest credit is not determined until the transaction is completed. An alternative would be to reduce the interest credit by a uniform tax rate.[70]

Receipt of an advance tax payment reduces the Treasury's need to borrow from other sources. But borrowing from taxpayers in this manner is disadvantageous if the interest credit

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[68] *See* I.R.C. § 460 (1986).

[69] *See* Shakow, *supra* note 2, at 1122–23 (deferral credit with respect to capital losses, where accrual not feasible due to valuation difficulties, should reflect the "interest the taxpayer could have earned on the tax savings from an immediate deduction of losses"). *Cf.* Halperin, *supra* note 3, at 531–33 (overpayment of tax may be treated as a loan from taxpayer to government at the private sector rate). *See generally* Land, *supra* note 3, at 298 (assumed interest rate would have to be used to determine credit compensating for excess tax payment since it is "impossible to know what the taxpayer might actually have earned on the excess tax"). If the interest credit is measured by the taxpayer's return on his investments, a taxpayer whose tax is accelerated would accumulate an after-tax amount no less than that accumulated by a taxpayer whose tax is not accelerated (and who earns an equivalent pre-tax return). Thus, there would be no inequity, and investments as to which tax is accelerated would not be discouraged.

[70] To avoid disadvantage to taxpayers, the tax rate would have to be the lowest tax rate for each year in which the interest credit accrued. But, in some cases, the lowest rate would be zero because of the availability of loss or credit offsets.

paid by the Treasury (as reduced by the tax paid to it thereon and increased by administrative costs) exceeds its usual borrowing costs (as reduced by taxes paid by lenders).[71]

### E. *Statutory Provisions*

It is difficult to discern a clear policy regarding the appropriate interest rate to be used in determining interest credits and charges from the interest provisions enacted by Congress in 1984 and 1986. A variety of rates were chosen for the different provisions, without any explanation.

The applicable federal rate is employed under section 453C(e) of the Code (compensating for deferral under the installment method).[72] Similarly, the interest rate for 12-month Treasury bills is used under section 995(f) of the Code (compensating for deferral of accumulated DISC income).[73] The interest rate paid on tax overpayments, i.e., the federal short-term rate plus two percentage points, is used under section 460 of the Code (correcting errors in applying the percentage of completion method).[74] This same rate is used[75] whether interest is owed to

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[71] *See* Halperin, *supra* note 3, at 532 ("government loses when it borrows [from taxpayers] at a private sector rate which is higher than its normal rate").

[72] *See* I.R.C. § 453C(e)(4)(B) (1986). The choice of this rate would seem to indicate rejection of the argument for using a private borrowing rate when valuation difficulties are not an obstacle to accrual taxation. *See supra* notes 58–64 and accompanying text. Taxpayers eligible to pay this deferral charge have the option instead to pay the current tax (to the extent required by the proportionate disallowance rule). *See supra* notes 4, 13 & 27–28 and accompanying text.

[73] I.R.C. § 995(f)(1)(B) and (4) (1986).

[74] I.R.C. § 460(b)(3)(C) (1986). *See* I.R.C. § 6621(a), (b) (1986), *amended by* TRA 1986, *supra* note 4, § 1511(a) (setting underpayment rate at three percentage points above the federal short-term rate and overpayment rate at two percentage points above the federal short-term rate). The committee report explains that different rates are appropriate for underpayments and overpayments since "[f]ew financial institutions, commercial operations, or other entities, borrow and lend money at the same rate." It notes that if the rates employed for these purposes are "out of line with general interest rates in the economy," this would cause taxpayers "to delay paying taxes as long as possible to take advantage of an excessively low rate or to overpay to take advantage of an excessively high rate." SENATE REPORT, *supra* note 4, at 184.

[75] The use of the same rate to determine the interest credit and the interest charge under I.R.C. § 460 (1986) contrasts with the use of a lower rate with respect to overpayments than with respect to underpayments of tax under I.R.C. § 6621 (1986). *See supra* note 74.

the taxpayer or to the Treasury.[76] The interest rate charged on tax underpayments, i.e., the federal short-term rate plus three percentage points, is used under sections 1291 and 1294 of the Code (compensating for deferral of a United States investor's share of accumulated earnings of a PFIC).[77] The same rate is used, whether or not there are valuation difficulties precluding imposition of a current tax.[78]

### F. *Conclusion*

In summary, the interest rate for determining an interest charge on tax deferral loans should be the taxpayer's after-tax rate of return on investments. In order for the interest charge to be administrable, a uniform rate has to be used even though it cannot be set at a level that would be accurate for all taxpayers. The applicable federal rate is generally the most appropriate rate for this purpose. The applicable federal rate would be too low for many taxpayers; however, no higher rate could be chosen that would not be too high for a large number of taxpayers.

While a current deduction of the interest charge in each year as it accrues would be accurate, it may not be feasible. The alternatives—delayed deduction of the interest charge or use of an assumed tax rate to determine an after-tax interest rate—are less accurate. If an after-tax interest rate is determined by reference to the highest applicable tax rate in each year that the interest charge accrues, no taxpayer will be disadvantaged by use of an assumed rate, although lower-bracket taxpayers will not pay full compensation for deferral.

The inaccuracy inherent in the determination of the appropriate interest rate is a reason for favoring accrual taxation, where practicable, over an interest charge. If accrual is not practicable, however, Congress should impose an interest

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[76] The relatively high rate for interest owed to the Treasury may be designed to eliminate any temptation for taxpayers to err on the side of underestimation in determining income from partial performance. The use of a relatively high rate to determine the interest credit insures that taxpayers who overestimate income from partial performance are fully compensated for the acceleration of their tax liability. *See supra* text accompanying notes 68–69.

[77] *See* I.R.C. § 1291(c)(3) (1986) (interest rate on underpayments); *id.* § 1294(a)(1) (interest rate on extensions). *See supra* note 74.

[78] *See supra* notes 6, 56–64 & 77 and accompanying text.

charge at a relatively low rate rather than forego any compensation whatsoever for tax deferral.[79]

## IV. Time and Method of Determining Interest Charge

The interest charge for any period is calculated by determining the amount of the tax deferral loan outstanding during that period and then multiplying that amount by the appropriate interest rate for the period.[80] The most appropriate method for making these calculations may depend upon such factors as the reasons for permitting deferral, the degree of accuracy desired, and the number of prior years from which income has been deferred.

### A. *Determination of Interest Charge on a Current Basis*

In some cases in which taxpayers are permitted to report income on a deferred basis, the amount of the income can be readily determined on a current basis. This is true, for example, of changes in the value of marketable securities, increases in the cash surrender value of life insurance policies or deferred annuity contracts, and gains from installment sales or income from deferred compensation if the amount and timing of the future payments is fixed. The apparent justification for permitting deferred reporting of income in such cases is not the difficulty of valuing the asset or right to future payment, but rather concern about the taxpayer's liquidity.[81] Concern for liquidity is also the sole justification for tax deferral in the case of a

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[79] *See* Warren, *Comments*, *supra* note 2, at 161 ("preference for accrual taxation [of capital gains] where feasible is strengthened by failure of the deferral charge always to give the same results as accrual"; "[w]here accrual is not feasible, the deferral charge appears to be the second-best solution"). *But cf.* BLUEPRINTS, *supra* note 2, at 74 (use of a "single interest rate" for deferral charge on capital gains would "tend to move alternatives away from neutrality").

[80] *See infra* note 87 and accompanying text.

[81] *See supra* notes 27–28 and accompanying text (discussing rationale of the installment method). *See* Note, *supra* note 2, at 872 n.65 (gains with respect to marketable securities of publicly-held corporations should be accrued, but an alternative would be to permit tax liability to accrue with interest until the securities were sold). *See also* Shakow, *supra* note 2, at 1118–19, 1168–69, 1176 (arguing for accrual treatment of changes in the value of assets that are readily valued, such as marketable securities, with possibility of tax postponement with interest for taxpayers demonstrating liquidity problems). *But cf.* Halperin, *supra* note 3, at 17 (problems of liquidity need not be an obstacle to accrual taxation of deferred compensation if tax is withheld by employer).

United States investor in a PFIC that provides current earnings information.[82]

In these cases, the amount of the tax deferral loan, and consequently the interest charge, may be determined on a current basis.[83] One of the two following methods may be used to determine the interest charge.

### 1. Current Comparison Method

a. *General description.* Under the Current Comparison Method, the taxpayer determines his tax liability for each year using the rules providing for deferral of income or loss. He also determines the tax that would have been payable if, instead, accrual rules were applied to all transactions subject to the interest charge.[84] Any excess of the hypothetical accrual tax liability over the actual tax liability for the year is added to a cumulative account of the tax deferral loan made by the Trea-

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[82] For treatment of a United States investor in a PFIC that elects to provide such information and to be treated as a qualified electing fund, see *supra* note 6 and accompanying text; see also *infra* note 132 and accompanying text.

[83] *Cf.* Note, *supra* note 8, at 412–13 (proposing that interest charge with respect to use of installment method be determined and payable on a yearly basis). The Note does not give a precise explanation of how such yearly charges would be determined. It states only that "sellers would have to calculate the total amount of taxes on the installment sale as though the purchase price were to be paid in the year of sale." The interest would be computed "by applying" the applicable federal rate "to the unpaid amount of taxes." *Id.* at 414 n.59. *See also* Shakow, *supra* note 2, at 1176 ("system might have to provide for interest-bearing tax liabilities" with respect to accrued gains where liquidity problems were demonstrated); Note, *supra* note 2, at 872 & n.65 (tax liability for unrealized gains could be accrued—it "would increase or decrease each year" with changes in the asset's value; "the liability would incur interest, but would not be due until" disposition of the asset). A more complete description of a scheme for interest-bearing tax liabilities is provided by Vickrey. *See* Vickrey, *supra* note 22. Under his cumulative lifetime averaging proposal, all tax payments are viewed as "interest-bearing deposits in a tax guarantee account." *Id.* at 738–39. As discussed *infra* note 132 and accompanying text, the Tracing Method is used to determine the interest charge with respect to United States investors in a qualified electing fund.

[84] *Cf.* I.R.C. § 995(f) (1986) (imposing an interest charge on a shareholder's DISC-related deferred tax liability for the year). Under section 995(f), a taxpayer recomputes tax liability by including his "deferred DISC income" for the year. The excess of such recomputed tax liability over the actual amount of tax liability for the year is his DISC-related deferred tax liability. The interest charge for each year is computed by multiplying the DISC-related deferred tax liability for the year by the base period Treasury bill rate. The shareholder's "deferred DISC income" for the year is his pro rata share of accumulated DISC income for periods after 1984 as of the close of the computation year, reduced by distributions of such accumulated income following the close of the computation year. The computation year is the taxable year of the DISC which ends with or within the shareholder's taxable year preceding his current taxable year.

sury to the taxpayer.[85] Any excess of the actual tax liability over the hypothetical accrual tax liability is applied as a reduction of this account. (A negative account balance represents a loan made by the taxpayer to the Treasury.) This cumulative loan account is adjusted each year when the taxpayer files his tax return.[86]

The taxpayer computes the interest charge payable with each year's tax return by multiplying the loan balance outstanding during the taxable year by the federal short-term rate applicable to that year.[87] The interest charge is deducted in the taxable year to which it relates.[88]

The following example illustrates the application of the Current Comparison Method where there is a single transaction involving deferral. On January 1, 1987, an investor sells a parcel of land at a gain of $100,000, with payment to the seller to be made on January 1, 1990.[89] Since the sale is reported under the installment method, no portion of the gain is recognized in 1987 for purposes of computing actual tax liability for 1987. When the 1987 tax return is filed on April 15, 1988, however, a hypothetical accrual tax for 1987 is computed to take into account the $100,000 gain. Assuming that the tax rate that would have applied to the gain if recognized in 1987 is 33%, this hypothetical accrual tax would exceed the actual tax for 1987 by $33,000. This amount is added to the taxpayer's loan balance as of April 15, 1988. The loan balance remains at $33,000 throughout 1988, 1989, and 1990 since there would be no change in tax liability for 1988 or 1989 if the installment method had not been used.

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[85] The method of determining the interest charge under I.R.C. § 995(f) (1986) differs from the Current Comparison Method in that under section 995(f) no cumulative loan balance is maintained. Under section 995(f) the tax deferral loan is determined anew each year by computing the additional tax liability that would be incurred in that year if the shareholder included in income his share of accumulated income of the DISC for all years after 1984 through the immediately preceding year.

[86] The cumulative loan balance as of the due date for filing the return would be the cumulative excess of the aggregate tax payments that would have been made as of that time if accrual rules had applied over the aggregate tax payments that have actually been made as of that time.

[87] *See supra* text following note 48.

[88] This does not require recomputation of the current year's tax. The interest charge for the current year can be computed before the tax for the year is computed since the interest charge is not affected by the adjustment to the loan balance made as of the due date for the current year's return. *See infra* note 90 for an example. *Cf.* Prop. Treas. Reg. § 1.995(f)-1(d), 52 Fed. Reg. 3266 (1987) (interest charge deductible for purposes of computing tax liability but not for purposes of determining DISC-related deferred tax liability in computing interest charge).

[89] It is assumed that interest payments, determined at a market rate, are made annually by the buyer.

Assuming that the federal short-term rate for 1988, 1989, and 1990 is 10%, the taxpayer pays an interest charge of $3,300 with respect to each of these years with his return for each such year. The taxpayer also takes a deduction in each of those years for the $3,300 of interest charge incurred.

The taxpayer computes his tax liability for 1990 under the installment method by including the $100,000 of deferred gain. The taxpayer also calculates his accrual tax liability for 1990 without regard to the installment rules (thus omitting the $100,000 gain), and subtracts this hypothetical tax from his actual tax liability for 1990. Assuming that the tax rate applicable to the gain in 1990 is 28%, the actual tax is $28,000 more than the hypothetical tax. As of April 15, 1991, the taxpayer reduces the $33,000 loan balance by $28,000 to $5,000.[90]

b. *Administrative burden.* To employ the Current Comparison Method, a taxpayer must retain a record of his cumulative loan balance as of the beginning of each year. He must also complete a series of steps additional to those required if there were no interest charge. These steps would be set forth on a form provided by the Internal Revenue Service.[91] Most of these steps (the comparison of the hypothetical accrual tax with the actual tax, the adjustment of the loan balance by the difference between these two amounts, and the multiplication of the loan balance by the applicable interest rate) involve merely mechanical calculations.

The first step, computation of the hypothetical accrual tax liability, is more difficult, however. The taxpayer must adjust his taxable income by excluding income or loss deferred from a prior year, and by including income or loss deferred from the current year to a future year. This deferred income or loss may arise from a variety of transactions. The same adjustments to taxable income are already required, however, with respect to

[90] The sequence of computations made by the taxpayer in filing his 1990 tax return is as follows: he first computes the interest charge with respect to 1990 by multiplying the interest rate applicable to 1990 (10%) by the loan balance as of April 15, 1990 ($33,000). He then determines tax liability for 1990 by use of the installment method and with a deduction for the $3,300 interest charge with respect to 1990. This tax liability and the interest charge of $3,300 are paid with his 1990 return. Next, he computes a hypothetical tax liability for 1990 without application of the installment method (but with the deduction of the $3,300 interest charge for 1990). The difference between these two tax amounts is the adjustment to the loan balance as of April 15, 1991.

[91] *See, e.g.*, I.R.S. Form 8404 (1986); *supra* note 7 (determination of interest charge with respect to DISC-related deferred tax liability).

long-term contracts and many installment sales for purposes of determining alternative minimum taxable income.[92]

These adjustments to taxable income may necessitate further adjustments. They may affect the thresholds for deduction of medical, casualty, and miscellaneous itemized expenses and the percentage of income limitation on deduction of charitable contributions;[93] the phasing-out of personal exemptions, of the exemption from the alternative minimum tax,[94] and of the use of passive losses from actively managed real estate;[95] and the amount of a net operating loss, capital loss, or credit to be used in the current year or to be carried back or forward.[96] Adjustments made to loss or credit carryforwards in determining accrual basis tax liability for a prior year would need to be taken into account in determining accrual basis tax liability for the

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[92] In computing alternative minimum taxable income, income with respect to installment sales (other than those excluded from the scope of I.R.C. § 453C (1986)) is determined without regard to the installment method; income from a long-term contract is determined under the percentage of completion method. I.R.C. § 56(a)(3), (6) (1986).

[93] *See* I.R.C. §§ 67(a), 165(h), 170(b), 213(a) (1986). *But cf.* Prop. Treas. Reg. § 1.995(f)-1(d)(5), 52 Fed. Reg. 3266 (1987) (in recomputing tax liability to reflect deferred DISC income, in order to compute the interest charge on DISC-related deferred tax liability, adjustments in deductions, inclusions, or exclusions should be taken into account only to the extent that such adjustments do not result in amounts being carried back or forward to another taxable year). Thus, under the Proposed Regulation, the amount of the deduction for medical expense is redetermined since any disallowed amount could not be carried back or forward. The amount of the charitable deduction is not redetermined, however, since any amount disallowed by reason of the percentage of income limitation under section 170(b) may be carried forward. The taxpayer may not claim an increased net operating loss deduction as a result of inclusion of the deferred DISC income for the year, unless the net operating loss cannot be carried forward to a future year. *Id.* § 1.995(f)-1(d)(4), 52 Fed. Reg. 3266.

Under the pre-1976 throwback rules, deductions for medical expenses and charitable contributions and carryovers were required "to be recomputed to the extent affected by the hypothetical distribution" of trust income in the year of its receipt by the trust. *See* B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS § 81.5.4, at 81-52 (1981); Treas. Reg. § 1.668(b)-3A(b)(1) (1972). If the hypothetical distribution affected net operating loss carryforwards to subsequent years, the tax for those years was also to be recomputed. *Id.* § 1.668(b)-3A(b)(2). These items need not be recomputed under the present throwback rules. *See* B. BITTKER, *supra*, at 81-52; I.R.C. § 667(b)(1), (2) (1986).

[94] *See* I.R.C. §§ 1(g), 55(d)(3) (1986). *Cf.* Prop. Treas. Reg. § 1.995(f)-1(e)(2), 52 Fed. Reg. 3266 (1987) (the amount of alternative minimum tax is not taken into account in determining the DISC-related deferred tax liability).

[95] *See* I.R.C. § 469(i)(3) (1986).

[96] *See* I.R.C. §§ 172, 1211–1212 (1986). There may be a change in the current use either of a loss arising in the current year or a loss carried forward to the current year. The use of capital losses would be affected if adjustments to taxable income reduced or increased the availability of capital gains or up to $3,000 of ordinary income to be offset by capital losses. *See infra* notes 115–87 and accompanying text. If there were adjustments in the amount of passive income or investment income, this could affect the use of passive losses or investment interest incurred in the current year or prior years. *See* I.R.C. §§ 469(b), 469(d), 163(d)(1), 163(d)(2) (1986).

current year.[97] Certain of these adjustments might be omitted to avoid excessive complications.[98]

The redetermination of actual tax liability for any year after the tax return is filed, whether the result of an audit, refund claim, or loss carryback, would require redetermination of the hypothetical accrual tax liability for that year as well.[99] In the case of an audit adjustment or refund claim with respect to a prior year, both the adjustment to the loan balance as of the due date of the tax return for that year and the accrual of interest on the loan balance for the period thereafter would have to be recalculated.[100]

Taxpayers may engage simultaneously in more than one transaction or investment involving deferral (or acceleration) of tax liability to be corrected by the Current Comparison Method. This might be true, for example, of a dealer in property who reports his sales under the installment method, an investor who owns a number of marketable securities, or an investor who owns a whole life insurance policy and a marketable security. In such cases, the Current Comparison Method measures only the net adjustment to the loan balance as a result of all transactions involving deferral that are in progress or completed during the year. It does not identify the contribution to such adjustment made by any individual transaction. Nor does it separately identify a taxpayer's loan repayments in each year; instead these loan repayments are netted with new loan exten-

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[97] This contrasts with the treatment of carryforwards in determining DISC-related deferred tax liability. *See supra* note 93. For further discussion of the treatment of loss carryovers under the Current Comparison Method, see *infra* note 106 and accompanying text.

[98] *See supra* notes 93–94 (omission of certain adjustments under throwback rules or rules for determining DISC-related deferred tax liability).

[99] *Cf.* Prop. Treas. Reg. § 1.995(f)-1(j)(4), 52 Fed. Reg. 3266 (1987) (if DISC-related deferred tax liability changes as a result of a change in actual tax liability due to audit adjustment, adjustment is made in interest charge); *id.* § 1.995(f)-1(d)(3), 52 Fed. Reg. 3266 (DISC-related deferred tax liability is determined without regard to any net operating loss or capital loss carryback or any credit carryback to the year from any succeeding year).

[100] In the case of a loss carryback from the current year to a prior year, the actual tax liability for the prior year would be redetermined to reflect the actual carryback, if any. The hypothetical tax liability for the prior year would be redetermined to reflect the hypothetical carryback, if any. Any change in the difference between the hypothetical tax liability and the actual tax liability for the prior year would be reflected as an adjustment to the loan balance as of the due date of the return for the current year. The adjustment to the loan balance would not be made as of the due date of the return for the prior year since interest does not accrue on changes in tax liability for a prior year as a result of a carryback until the end of the loss year. *See* B. BITTKER, *supra* note 93, § 25.11.7, at 25–70.

sions.[101] This makes the Current Comparison Method simpler to apply, in many cases, than a method that separates loan extensions and repayments and then traces them to specific transactions. However, this aspect of the Current Comparison Method also results in some disadvantages.[102]

c. *Accuracy.*

(i) *Avoiding underpayment or overpayment of tax deferral loan.* In the land sale example above,[103] since the tax rate applicable to the gain in the year to which it is deferred (28%) is less than the tax rate that would have applied if the gain had not been deferred (33%), the tax deferral loan with respect to the land sale is not fully repaid when the transaction is completed.[104] Similarly, if the tax rates applicable in the two years had been reversed, the tax deferral loan would have been overpaid.[105] Overpayment or underpayment of the tax deferral loan could also occur (even assuming a single tax rate for all years)

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[101] For example, when a dealer in goods reports on the installment method, the Treasury each year makes a loan to the taxpayer of the tax with respect to income that is deferred from the current year to subsequent years; each year, the taxpayer repays previously obtained loans by paying the tax on income whose deferral has ended during the year. If the income deferred to the current year equals the income deferred from the current year, there is no net change in the loan balance. In recomputing tax liability without use of deferral rules, the taxpayer simultaneously (a) eliminates from taxable income all income earned in prior years that was deferred to the current year, and (b) adds to taxable income all income earned in the current year that is deferred to future years. Thus, the effect of these steps is only determined on a combined basis.

[102] *See infra* notes 107, 121 & 130 and accompanying text.

[103] *See supra* note 89 and accompanying text.

[104] *See* Andrews, *supra* note 1, at 1175–76:

> Tax deferral may result in a taxpayer being in a different marginal rate bracket when he finally is taxed than he would have been at the earlier point in time. A lower marginal rate of tax in a subsequent period may result either from the operation of a graduated rate system producing lower marginal and average rates in a lower income period, such as retirement, or from changes in the statutory rate schedule between the earlier and the later point in time.

*See also* Land, *supra* note 3, at 292 (marginal tax rate may fluctuate over term of contingent deferred payment obligation).

The applicable tax rates for the two periods might also vary because the taxpayer turned 14 years old during the period of deferral. In that case, his unearned income would be taxed at his parents' rate in the first year but at his own rate in the subsequent year. *See* I.R.C. § 1(i) (1986).

[105] If the deferred item is a loss, there would be similar possibilities for underpayment or overpayment of the tax acceleration loan owed to the taxpayer. The timing of the recognition of the loss might affect the tax rate applicable to the income against which the loss is offset or the availability of income to be offset by the loss.

if the utilization of losses or credits is affected by deferral of income.[106]

It would be desirable to provide for exact repayment of the tax deferral loan with respect to each transaction at the completion of the transaction. (Thus, in the example, the taxpayer should make an additional payment of $5,000 to the Treasury with his 1990 return, bringing the loan balance down to zero.) This is not possible under the Current Comparison Method, however, if there are other transactions subject to the interest charge that are still in progress. The amount of the loan extended with respect to each transaction and the amount of the loan repayment when the transaction is completed are not identified.

Consequently, correction of any overpayment or underpayment of a tax deferral loan must await conclusion of all transactions subject to the interest charge. At that point, the net amount of underpayment or overpayment would be reflected as a positive or negative cumulative loan balance. Delaying corrective payments until such time is potentially disadvantageous, since this time might be far in the future and also might not be a convenient time for the taxpayer to pay the accumulated net amount of underpayment, if any. The taxpayer might have spent the cash flow of prior years needed for this payment. Thus,

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[106] A net operating loss carryover that would have offset an item of income in the year that such income is earned may expire unused if the item of income is deferred to a later year (beyond the end of the carryover period). In that case, a loan repayment is made (when tax is paid with respect to the deferred income) but no tax deferral loan is, in fact, received. Thus, there is an overpayment by the taxpayer. (If deferral of the income does not cause the loss to expire unused but merely delays its use, a tax deferral loan arises in the year that the loss is used unless use of the loss is delayed until the year that the deferred income is recognized. In that case, no tax deferral loan arises, and there is no loan repayment since the item of income is offset by the loss whether or not the item of income is deferred.)

On the other hand, a net operating loss may offset an item of income at the time of recognition but might not have offset that item of income if the item had been reported when earned (at a time prior to the beginning of the loss carryback period). In that case, the tax deferral loan would be repaid only if and when the loss would have been utilized in the absence of income deferral. (Until that time, the loss carryforward for purposes of hypothetical tax liability would be in excess of the loss carryforward for purposes of actual tax liability.) Thus, loan repayment might occur after completion of the deferral transaction or might never occur (because, in the absence of deferral, the loss would have expired unused).

Correction of any overpayment or underpayment of the tax deferral loan could occur only when all deferral transactions have ended. *See infra* note 107 and accompanying text. When such correction occurs, the taxpayer's loss or credit carryovers should be adjusted to equal the amount of such carryovers if deferral had not been permitted. Otherwise, the tax deferral loan might, in effect, be paid twice. This could occur if the loss or credit carryover for purposes of the hypothetical tax is greater than the carryover for purposes of the actual tax, as described in the preceding paragraph.

there might be a serious risk of default by taxpayers.[107] Nonpayment by taxpayers would make the interest charge less accurate than accrual taxation.[108]

This problem is eased by the relatively flat rate schedules set by the 1986 legislation, which reduce the likely size of loan underpayments or overpayments.[109] The problem would become more serious, however, if future tax legislation introduces greater variation in rate schedules, e.g., by adding a new individual tax bracket above the present ones.

(ii) *Timing of tax payments within a taxable year.* Under the Current Comparison Method, no attempt is made to measure changes in the loan balance occurring within a taxable year. Such changes may occur because deferral of income or loss may affect both the extent to which tax liability is payable in quarterly estimated installments[110] and the relative size of the required installment for each quarter.[111] To measure these changes in the loan balance, it would be necessary to determine the

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[107] Since the Treasury would be expected to refund any negative loan balance when due, any balance remaining unpaid after it is due would, practically speaking, be a balance owed to (and not by) the Treasury. It might be preferable to forgive any remaining loan balance (positive or negative) at the conclusion of all deferral transactions to avoid excessive revenue loss. However, this would provide opportunities for manipulation by taxpayers. If a taxpayer had a positive loan balance, he would seek to terminate temporarily all transactions involving deferral in order to obtain forgiveness of the loan balance. If a taxpayer had a negative loan balance, he would seek to keep this balance outstanding (and bearing interest) for as long as possible.

[108] If the remaining positive (or negative) loan balance is not paid, some inequity and distortion of behavior would persist. The seller of the land, in the example in text, would be better off lending the sale proceeds to the buyer until 1990 (through an installment sale), than collecting the proceeds promptly and investing them in an otherwise comparable debt instrument of a third party. He would pay an interest charge to the Treasury in each of the years 1988, 1989, and 1990 fully compensating for the use of the proceeds of the tax deferral loan in those years, but $5,000 of the loan would then be forgiven (if there were no other deferral transactions in progress).

[109] *See infra* notes 256–61 and accompanying text.

[110] Estimated tax payments, together with withholding from wages, must equal in the aggregate at least 90% of the tax liability shown on the return for the taxable year, or, if less, at least 100% of the tax shown on the return for the preceding year. I.R.C. §§ 6654(d)(1)(B), 6655(b)(1), 6655(d)(1) (1986). Reliance on the tax shown on the prior year's return is not permitted for a "large corporation," i.e., a corporation whose taxable income was at least $1 million in any of the preceding three years. *Id.* § 6655(i).

[111] Generally, required estimated payments are equal in each quarter. In the case of a corporation, four equal installments are usually required on the 15th day of the fourth, sixth, ninth, and twelfth months of the taxable year. *Id.* § 6154(b). In the case of an individual, four equal payments are generally required on April 15, June 15, September 15, and January 15 of the following year. *Id.* § 6654(c), (d)(1)(A). As an alternative, however, the taxpayer is permitted to determine the estimated tax payment for a quarter by annualizing income earned through the end of that quarter. *See Id.* §§ 6654(d)(2), 6655(d)(3). For further discussion, see *infra* note 269 and accompanying text. *See also* I.R.C. § 6655(e) (1986) (special treatment of recurring seasonal income of corporations).

amount of the estimated tax payment for each quarter that would be required with respect to the hypothetical accrual tax liability.[112] These hypothetical payments would then be compared on a quarterly basis with the tax payments actually required, in order to determine quarterly adjustments to the loan balance.[113]

Nevertheless, determination of the loan balance should be made only on an annual basis. Computing the loan balance on a quarterly basis would involve intolerable complexity. Moreover, the inaccuracy from annual determinations may be relatively small.[114]

(iii) *Limitation on capital losses.* The current limitation on the use of net capital losses may have to be retained, even in the case of a net loss derived from marketable securities subject to the interest charge (or credit). The amount of such a loss

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[112] In determining the required estimated payments with respect to the hypothetical accrual tax liability for the year, 90% of the hypothetical tax for the year would be compared with 100% of the hypothetical tax for the prior year. *See* I.R.C. § 6654(d)(1)(B) (1986).

[113] This can be illustrated by continuing the example in text accompanying note 89. When the taxpayer determines the hypothetical accrual tax for 1987 (by including the $100,000 gain in income for that year), he would also determine when that tax would be paid. Assume that 90% of the hypothetical tax liability for 1987 is no greater than 100% of the hypothetical tax liability for 1986. In that case, the hypothetical 1987 tax attributable to the gain ($33,000) would be subject to estimation to the extent of 90% and, thus, would be payable in four installments of $7,425 on the four estimated tax payment dates, with the remaining $3,300 payable when the tax return is due. (This assumes that the annualized income installment method is not able to be used. *See supra* note 111.) Thus, the loan balance would be $7,425 on April 15, 1987; $14,850 on June 15, 1987; $22,275 on September 15, 1987; $29,700 on January 15, 1988; and $33,300 on April 15, 1988. Assume further that 90% of the actual tax liability for 1990 (determined without regard to the installment gain) is greater than 100% of the actual tax liability for 1989. Thus, the tax on the installment gain recognized in 1990 ($28,000) would not be subject to estimation but would be payable in full on April 15, 1991. Thus, the loan balance would be reduced by $28,000 on April 15, 1991. In this example, when the loan balance is determined on a quarterly basis instead of on an annual basis, a portion of the loan balance is outstanding for a lengthier period and the interest charge is greater.

If, on the other hand, 90% of the tax imposed on the installment gain in 1990 would have been due in equal quarterly installments, an annual determination of the loan balance would yield the same results as a quarterly determination, except as far as the $5,000 loan underpayment is concerned. The loan balance would be reduced by $6,300 on each of the quarterly payment dates, and by $2,800 on April 15, 1991. Thus, except for the $5,000 underpayment, $28,000 of the loan balance would have been outstanding for exactly one year (although different portions would have been outstanding during different periods).

[114] If the timing within a taxable year of tax payments attributable to deferred income would be the same whether the income was reported on a cash basis or on an accrual basis, then the Current Comparison Method would accurately measure the period for which the tax deferral loan was outstanding. This would be true if the tax attributable to the deferred income would not be subject to estimation in either case or would be subject to estimation, to the extent of 90%, and payable in equal quarterly installments, in either case. *See supra* note 113.

might be no more than the amount of an unrealized gain that is not reflected in the determination of the hypothetical accrual tax liability, since it is derived from a nonmarketable capital asset that is not subject to the interest charge.[115] Application of the limitation on capital losses would result, however, in inappropriate deferral (or elimination) of the tax savings attributable to a loss if there is in fact no such unrealized gain of equal size. If the capital loss limitation is retained under the Current Comparison Method, it should be applied in determining both the actual tax liability and the hypothetical accrual tax liability.[116]

d. *Liquidity*. Under the Current Comparison Method, rules permitting taxpayers to defer reporting income from an activity or investment until cash is received therefrom remain in effect. Thus, tax payments may be made from the cash receipts derived from the transaction.

If, however, the interest charge must be paid annually as it accrues, the taxpayer will need to find another source of cash to make interest payments. Congress might decide that this is not an undue burden for taxpayers, even if current payment of the tax would be overly burdensome.[117] Requiring annual inter-

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[115] Nonmarketable capital assets might, however, be subject to an interest charge determined by hindsight. *See infra* notes 196–206 & 233–36 and accompanying text; *see also* text following note 330. In that case (and assuming constructive realization or carryover basis for such assets at death), the capital loss limitation need not be retained. *See* Wetzler, *supra* note 2, at 121, 132–34 (elimination of capital loss limitation in connection with interest charge or credit for all capital assets, combined with carryover basis at death).

[116] If the limitation were applied only in determining actual tax liability, the taxpayer might receive the tax savings attributable to the loss (along with an interest credit) when all transactions subject to the interest charge were terminated and any remaining negative loan balance became payable. The tax savings blocked by this limitation should not be subject to an interest credit since the tax deferred with respect to an offsetting unrealized gain from a nonmarketable asset would not be subject to an interest charge. *See supra* note 115 and accompanying text.

[117] *See* Note, *supra* note 8, at 413 (arguing that proposed interest charge with respect to installment method should be payable on an annual basis). The Note author observes that "the interest charged to the seller would constitute only a small fraction of the total amount of the taxes on the installment sale and would therefore be unlikely to create significant hardship for most installment sellers" particularly if the installment seller is receiving "yearly interest payments." The above author further notes that even if the installment seller is not receiving yearly interest payments, the tax on the interest income may have to be paid currently under I.R.C. § 1274 (1986). In addition, the Note author suggests that delaying payment of the interest charge until receipt of installment payments would fail to eliminate the current potential for abuse; installment payments might be deferred "until a single occasion far in the future that would never actually occur." Note, *supra* note 8, at 413 & nn.53–54. The interest charge with respect to accumulated DISC income is imposed on a current basis. *See supra* notes 84–85. The interest charge with respect to accumulated income of a qualified electing fund is apparently

est payments would be advantageous to the Treasury. It would reduce the amount of the Treasury's loans to taxpayers, and would consequently reduce the Treasury's borrowing needs. It might also improve the likelihood that interest charges would be collected from untrustworthy taxpayers.[118]

If, however, a requirement of current interest payments is considered to involve too much potential for hardship, the interest charge could be compounded. The interest charge would, nevertheless, be deducted as it accrues.[119]

To insure coordination of interest payments with cash receipts from the transaction, payment of the accrued interest charge should be required at the same time as payment of the deferred tax to which the interest charge is attributable. This approach cannot be used under the Current Comparison Method, however, since the amount of the tax deferral loan repaid to the Treasury during the year is not separately identified (due to netting of loan payments with new loan extensions).[120]

Instead, a taxpayer might be required to pay accrued interest up to a specified percentage of his after-tax income from all sources. (A taxpayer would also have the option of making current payments of accrued interest, but not of deferred tax liability, beyond those required.)[121] Assuming that marketable securities are subject to the interest charge, interest payments might be required to the extent of the year-end value of those securities, absent a showing of difficulty in liquidating them.[122]

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payable only when the deferred tax liability is paid, although the interest could be computed on an annual basis. *See* I.R.C. § 1294 (1986); BLUEBOOK, *supra* note 4, at 1029. *See infra* note 132.

[118] For collection problems where interest is compounded, see Shakow, *supra* note 2, at 1169–70 (discussed *supra* note 22).

[119] *See supra* notes 51–53 and accompanying text.

[120] *See supra* note 101 and accompanying text.

[121] It would not be desirable to permit the interest charge to be compounded until all deferral transactions are completed. This would often result in an indefinite delay of the interest payment. Moreover, this would not insure good coordination with cash receipts of the taxpayer. There would be no assurance that the taxpayer would not have spent cash flow of previous years that would be needed to pay a huge accumulation of interest. Thus, the Treasury would bear a very serious risk of default.

Prepayment of a positive loan balance would create difficulties because a loan repayment would also be made when deferred income was recognized. This would result in a negative loan balance, which ordinarily would be repaid only upon completion of all transactions subject to deferral. *See supra* notes 107–08 and accompanying text.

[122] Such difficulties might arise, for example, for a taxpayer who held a large, but not a controlling, interest in a company whose stock was held in part by the public. A sale by the taxpayer of a major portion of his stock might substantially depress the market price. *See* Note, *supra* note 2, at 865 n.33. In general, though, a major portion of the stock would not need to be sold solely to pay accrued interest.

In this way, compounding of interest could potentially be limited to situations in which prompt payment would create hardship.[123]

e. *Treatment of pass-thru entities.* Tax liability attributable to income of a partnership or S corporation is determined at the level of the individual partner or shareholder.[124] Thus, the interest charge would also be determined at that level. Each member of the entity would compare his actual tax liability for the year with his hypothetical accrual tax liability to determine the adjustment to his individual loan balance and his individual interest charge.[125]

In order to facilitate these computations on the part of individual partners or shareholders, the entity would determine its taxable income in two ways: first with the benefit of deferral and then without the benefit of deferral. The entity would then allocate taxable income determined in each of the two ways among its members.

It might be difficult for the entity to allocate among members the taxable income determined without the benefit of deferral rules. If deferral rules were applied for purposes of internal entity accounting as well as for tax purposes, the division among members of deferred income would not be determined by the entity until deferral ended. If it turned out that the tax allocations made initially did not conform to allocations made for internal purposes when deferral ended, adjustments to the tax allocations would have to be made at that time.[126] (These ad-

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[123] *See* Shakow, *supra* note 2, at 1176 (tax on accrued gains with respect to assets that can be readily valued might be postponed only to the extent that tax exceeds specified percentage of other income and only for taxpayers who "could demonstrate that liquidity problems existed for them"). *See also* 2 TREASURY I, *supra* note 8, at 395–97 (proposal for conditioning extensions for payment of estate tax on showing of lack of available liquid assets).

[124] I.R.C. §§ 701, 702(a), 1363(a), 1366(a) (1986).

[125] *Cf.* Prop. Treas. Reg. § 1.995(f)-1(h)(1), (2), 52 Fed. Reg. 3266 (1987) (each partner and S corporation shareholder is to take into account his share of deferred DISC income and to determine his DISC-related deferred tax liability and interest charge thereon as if he directly owned stock in the DISC).

[126] These problems can be illustrated by the example of a professional partnership that computes tax liability on a cash basis. It is assumed that shares of partnership profits are determined on a cash basis; thus, profit-sharing ratios in the year that income is collected govern its distribution among partners.

Each partner would determine his interest charge by comparing his tax liability based upon allocations to him under the cash method and his tax liability based upon allocations to him under the accrual method. Allocations of accrual basis taxable income would have to be made before the partnership determined to whom uncollected income would be distributed. Subsequent adjustments would have to be made to allocations of accrual basis taxable income to reflect changes in profit shares. This would insure that justments are the same as would be needed if the entity were required to compute actual tax liability without the benefit of deferral, instead of paying an interest charge.)[127] These difficulties would not be present, however, if deferral rules were not applied for purposes of internal entity accounting.

f. *Loan balances remaining at death.* A taxpayer could be required to pay his remaining positive loan balance (or be entitled to receive a refund for a remaining negative loan balance), including accrued interest, with his final tax return. This would assure full compensation to the Treasury for the benefits of deferral.[128] But requiring immediate payment of any positive loan balance at death is inconsistent with the goal of avoiding the liquidity problems that would arise under accrual rules; the estate may be in no better position to make payment at death than was the decedent prior to his death.

Another alternative that would assure full compensation for deferral benefits is for the decedent's successor to succeed to the decedent's obligation to pay the tax and interest charge with respect to deferred income in accordance with the Current Comparison Method. This, however, would not be feasible.

To accomplish this, not only the deferred income[129] but also the decedent's cumulative loan balance must carry over to the

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capital accounts, as computed based upon accrual method allocations of taxable income, would correspond to liquidating distributions.

For example, when a partner retired, his allocation of taxable income under the accrual method would be adjusted so that his capital account would not reflect receivables outstanding on the date of retirement. The effect would be that the retiring partner would have an excess of cash method tax over accrual method tax in the year of retirement. Thus, he would repay the tax deferral loan extended to him with respect to his share of partnership income. The other partners would have a corresponding excess of accrual method tax over cash method tax for the year of the retirement; thus, they would in effect assume the retiring partner's tax deferral loan.

[127] *See supra* note 26.

[128] Elimination at death of any remaining (positive or negative) loan balance, even if combined with carryover of deferred income of the decedent to his successor, would not result in complete elimination of the benefits of deferral. Previously accrued interest with respect to tax deferred by the decedent would be forgiven. No additional interest would accrue with respect to such deferred tax even though deferral continues. The tax paid by the successor, when the income is recognized, would be paid at his own applicable tax rate, which might differ from the decedent's tax rate that would have applied in the year that the income was earned. *See* Wetzler, *supra* note 2, at 121–22 (proposal for carryover basis at death, with deferral charge, differs from accrual taxation in that gain is taxed at marginal rate of successor).

[129] Under present law, income in respect of a decedent carries over to the successor, but unrealized gain or loss in capital assets does not; unused loss or credit carryovers of the decedent expire at death. *See* I.R.C. § 691 (1986) (income in respect of a decedent included in income by estate or other person collecting income); *id.* § 1014(a) (basis for

persons inheriting the decedent's assets. A precise allocation of the loan balance among heirs would not be possible, since under the Current Comparison Method it would not be known what portion of the loan balance was attributable to each asset. Moreover, a portion of the loan balance might be attributable to underpayments or overpayments of tax deferral loans with respect to assets no longer held.

The best solution would be to require the loan balance (positive or negative) to become due at death, but to allow the estate a postponement (for as many as fifteen years) if it could demonstrate that it did not have liquid assets sufficient to make payment.[130] During the period of postponement, the loan balance would continue to bear interest. While the determination of eligibility for the postponement would be a burden on the Internal Revenue Service and the estate, the burden would be limited to once in each taxpayer's lifetime.[131]

### 2. Tracing Method

a. *General description.* An alternative to the Current Comparison Method is the Tracing Method. Under the Tracing Method, the tax deferral loan is identified with the specific items of income that give rise to it. This method of determining an interest charge is applied under section 1294 of the Code to a United States investor in a PFIC that provides current earnings information and makes an election as a qualified electing fund.[132]

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other assets received from decedent is fair market value at date of death or alternate valuation date). For carryover basis with respect to capital assets, see I.R.C. § 1023 (repealed 1980). The reason for repeal was said to be administrative problems—"a significant increase in the time required to administer an estate," an increase in the "overall cost of administration," and the undue complexity of the provision. S. REP. No. 394, 96th Cong., 1st Sess. 122 (1979), *reprinted in* 1980-3 C.B. 131, 240.

[130] *Cf.* 2 TREASURY I, *supra* note 8, at 395–97 (proposal to revise I.R.C. § 6166 (1986) so that postponement of payment of estate tax would be permitted only to the extent that the estate could show a lack of cash or readily marketable assets available for this purpose). *See also* Shakow, *supra* note 2, at 1176 (proposal to postpone payment of tax on accrued capital gains upon showing of liquidity problems).

[131] *Cf.* Wetzler, *supra* note 2, at 120 (once-in-a-lifetime valuation of capital assets, required for constructive realization of gain or loss at death, should not be considered onerous). Under the Treasury's proposed revision of I.R.C. § 6166, the determination of eligibility to postpone payment of estate tax is fairly mechanical. *See* 2 TREASURY I, *supra* note 8, at 395–97.

[132] I.R.C. § 1294 (1986). *See supra* notes 6, 31 & 82 and accompanying text. The investor determines his tax liability in each year by including in income his share of current PFIC earnings. I.R.C. § 1293 (1986). But he may elect to extend payment of the portion of his tax liability attributable to the inclusion in income of current earnings that are undistributed. *Id.* § 1294(a). This portion of his tax liability is determined by

Under the Tracing Method, the taxpayer determines his tax liability on an accrual basis. He is permitted an extension, however, for the payment of the portion of the tax liability attributable to income accrued but not realized during the taxable year (or not reportable as a result of use of the installment method). In order to determine the portion of the tax liability to be deferred, the taxpayer determines the hypothetical tax that would be payable if the accrued but unrealized income were deferred, and then subtracts this hypothetical tax liability from the actual (accrual) tax liability.

The deferred tax liability becomes payable in the subsequent year in which the accrued but unrealized income is realized. If only a fraction of the unrealized items from a prior year are realized in a subsequent year, only that fraction of the deferred tax liability is then payable. Interest accrues with respect to the deferred tax liability from the due date of the return for the year in which the deferred tax liability is determined, until the due date of the return for the year in which the deferred tax liability becomes payable.

Accrued interest on the deferred tax liability is determined and deducted annually. The accrued interest could be payable either on an annual basis, or only as the deferred tax liability becomes payable. In the latter case, if only a fraction of the remaining deferred tax liability from a prior year is payable in the current year, only that fraction of the unpaid accrued interest would be payable. Alternatively, required payments of accrued interest might be determined in some other manner, as discussed above.[133]

b. *Relative advantages and disadvantages.* The Tracing Method avoids two of the difficulties of the Current Comparison

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subtracting from his entire tax liability the tax that would have been payable if there had been no inclusion in income of the current PFIC earnings that were not distributed. *Id.* § 1294(b). In a subsequent year when the PFIC earnings attributable to that prior year are distributed (or the stock is sold), the deferred tax liability becomes payable with accrued interest. *Id.* §§ 1293(c), 1294(c). Distributions of PFIC earnings are deemed to be made from the most recently accumulated earnings. *Id.* § 1294(c)(1)(B). The Treasury has authority to require a bond securing payment of the deferred tax liability; moreover, the Treasury may terminate tax deferral if it believes collection is in jeopardy. *Id.* § 1294(c)(3), (e). *See generally* BLUEBOOK, *supra* note 4, at 1029–30.

[133] *See supra* notes 122–23 and accompanying text. Under section 1294, the accrued interest is payable only as the deferred tax liability becomes payable. I.R.C. § 1294 (1986). *See supra* note 132.

Method. First, under the Tracing Method the deferred tax liability that is paid when previously unrealized income is realized is the same amount that would have been paid under an accrual system, notwithstanding any changes in tax rates between the time that the income accrues and the time that it is realized. Secondly, payment of the interest charge can be required at the time of payment of the deferred tax liability with respect to which the interest accrued. This permits the taxpayer to pay the interest charge from cash receipts derived in the transaction subject to tax. This is only an advantage, however, if Congress wishes to permit deferral of interest payments to this extent.[134] A further advantage of the Tracing Method is that prepayment by taxpayers of deferred tax as well as interest can easily be accommodated.

The Tracing Method does not avoid three other difficulties arising under the Current Comparison Method, however. First, it is not feasible for heirs to succeed to the decedent's obligation to pay deferred tax liability and accrued interest thereon when previously accrued income is realized by the heirs; allocating the deferred tax liability among various heirs, while possible, would be too difficult. As under the Current Comparison Method, the deferred tax liability should instead become due at death, subject to an extension (with interest) granted to any estate with demonstrated liquidity problems.[135]

Secondly, application of the Tracing Method to a pass-thru entity would involve difficult adjustments if the entity applies deferral rules for purposes of internal entity accounting. As under the Current Comparison Method, income would have to be determined for tax purposes and allocated among members in the year that it was earned; such allocation might require correction when the income is divided among members under internal entity accounting at the time that deferral ends.[136]

Finally, the Tracing Method, like the Current Comparison Method, is not entirely accurate in measuring the period for which tax liability is deferred (during which interest should accrue). It fails to take into account the fact that income deferral may affect the extent to which tax liability is payable in quarterly

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[134] *See supra* notes 117–23 and accompanying text.
[135] *See supra* notes 128–31 and accompanying text.
[136] *See supra* notes 126–27 and accompanying text.

estimated installments.[137] Yet a more precise determination of the deferral period would be impractical.[138]

In addition to having these drawbacks common to both methods, the Tracing Method is more complex to apply than the Current Comparison Method in many situations. Like the Current Comparison Method, the Tracing Method requires that the taxpayer segregate his income into three categories: income earned in a prior year but realized in the current year; income earned and realized in the current year; and income earned in the current year, but realized in a subsequent year. As under the Current Comparison Method, a second computation of tax liability must be made in any year in which income earned during the year remains unrealized.[139]

Under the Tracing Method, however, there are two additional requirements. First, the taxpayer must assign income realized in the current year but earned previously to the particular prior year in which it was earned. Secondly, the taxpayer must determine the portion of the deferred tax liability (and accrued interest thereon) for each such prior year attributable to the income realized currently. Therefore records must be kept of (1) the deferred tax liability for each prior year plus accrued interest thereon (less amounts already paid); (2) the aggregate amount of earned but unrealized items for each prior year (less amounts already realized); and (3) the year in which unrealized items were earned.

In the case of repeated or long-term transactions, these additional steps may be very burdensome. This would be true, for example, for a dealer reporting sales under the installment method. In each year, he would have to determine the portion

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137 *See supra* notes 110–13 and accompanying text. The taxpayer would not be able to use the annualized income installment method to determine the size of the required installment for each quarter. *See infra* note 145 and accompanying text. Thus, estimated payments would be of equal size in each quarter. *See supra* note 111.

138 Under the Current Comparison Method, the existence of a loss (which is itself deferred or which offsets deferred income) may result in overpayment or underpayment of a tax deferral loan. *See supra* note 106 and accompanying text. Under the Tracing Method, the existence of a loss may, in some cases, cause accrued income or loss to be taken into account in determining required tax payments prior to realization. The item would be taken into account if it affects accrual basis tax liability in a year following that in which it accrues. This would be true in the case of an unrealized loss used to offset gain in a year following accrual of the loss, or in the case of unrealized income that, in the year of its accrual, absorbs a net operating loss that otherwise would have been used in a subsequent year.

139 Under the Current Comparison Method, a recomputation of tax is also required in any year in which there is a realization of income earned in a prior year. *See infra* note 92 and accompanying text.

of the accrual tax liability for the current year that is to be deferred. Records would have to be maintained of the deferred tax liability for the year, and of the aggregate amount of accrued income for the year that is deferred under the installment method. In each year, he would determine the interest accruing on deferred tax liability from each prior year so that such interest could be deducted (and perhaps paid) currently. In each year, he would also determine the amount of deferred tax liability (and unpaid accrued interest, if any) from prior years that is to be paid currently. This would require determining, for each installment received in the current year, the year in which the installment was earned. It would also require determination of the fraction of the remaining deferred tax liability for each such prior year attributable to current installments.

Complications may be even greater in applying the Tracing Method to accrued capital gains and losses with respect to marketable securities. In each year of a security's holding period, gain or loss might accrue. It would be necessary in each year to determine the aggregate tax liability (or tax savings) attributable to accrued but unrealized gains or losses; this tax liability (or tax savings) would then be deferred. (If the capital loss limitation is retained,[140] tax savings would be treated as being deferred and would bear interest only if a net accrued but unrealized loss offset a realized gain or up to $3,000 of ordinary income.)[141]

Whenever a capital asset is sold, it would be necessary to determine the deferred tax liability (or tax savings) to be paid (or refunded), and the unpaid accrued interest thereon, with respect to each prior year of the holding period. This would require that the investor keep a record of the annual changes in the asset's value in each year of the holding period, as well as of the aggregate amount of accrued but unrealized items and the aggregate deferred tax liability (or tax savings) for each prior

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[140] *See* I.R.C. § 1211(b) (1986); *supra* note 115 and accompanying text.

[141] In that case, the hypothetical tax liability determined without regard to the unrealized loss would be greater than the accrual tax liability. The excess of the hypothetical tax liability over the accrual tax liability would be payable currently, but would be refunded (as deferred tax savings) when the loss is realized.

Accrued but unrealized loss in excess of realized or unrealized gains and up to $3,000 of ordinary income would not be taken into account in determining accrual tax liability. Thus delay in realization of the loss would not be deemed to result in any deferral of tax savings subject to an interest credit.

year. These complications would be compounded for an investor with a large portfolio.

An additional complication would arise if offsetting gains and losses from two or more assets accrue but remain unrealized in a particular year. The net unrealized gain or loss would be taken into account to determine the portion of the tax liability (or the tax savings) to be deferred. When one of the assets is sold and gain or loss accrued in the prior year is realized, this would trigger the payment (or refund) of the deferred tax liability (or tax savings) for the prior year only to the extent that the realized gain (or loss)[142] is in excess of as yet unrealized offsetting items accrued in the prior year.

Determination during the year of the required estimated tax payments also involves complications under the Tracing Method. Under the Tracing Method, tax liability[143] for the year does not include the portion of the accrual tax liability eligible for deferral, but does include deferred tax liability from a prior year that is payable in the current year.[144] These amounts may be difficult to estimate before the end of the year. Application of the annualized income installment method to determine the distribution of estimated tax payments during the year may not be possible if the Tracing Method is used.[145]

In some cases, however, the Tracing Method may be less complicated to apply than the Current Comparison Method. This would be true if the taxpayer made an isolated installment sale involving several installments, but had no other investments or activities that are subject to an interest charge determined on a current basis. In that case, under the Current Comparison Method, tax liability would be recomputed in each year in which

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[142] If an asset has increased in value in one year and declined in value in another year, the gain or loss realized on sale would reflect a netting of these changes in value. At the time of sale, the amount of any gain or loss accrued with respect to the asset in any prior year would be deemed to be realized for purposes of determining the portion of the deferred tax liability (or tax savings) from such prior year that is currently payable.

[143] Estimated tax payments for the year (together with withholding from wages) must equal in the aggregate at least 90% of the tax liability for the year (or, if less, at least 100% of the prior year's tax liability). *See supra* note 110.

[144] *See supra* note 133 and accompanying text.

[145] Under the annualized income method, the taxpayer determines the required estimated tax payments through the end of a quarter by annualizing income derived through the end of that quarter. *See supra* note 111; *see also infra* note 269. Under the Tracing Method, a portion of the tax payable during the year is attributable to income reported in a prior year, and a portion of the income reported in the current year generates a tax liability payable only in a subsequent year.

an installment is received, as well as in the year of sale.[146] In contrast, under the Tracing Method, tax liability would be recomputed only in the year of sale, to determine the deferred tax liability for that year. When an installment is received, there would be no difficulty in identifying the year of sale, and thus the deferred tax liability attributable to the sale. The taxpayer would determine the portion of the remaining deferred tax liability (and accrued interest) to be paid during the current year based upon the percentage of the previously unrecognized gain from the sale that is recognized in the current year.[147]

#### 3. Summary

The Tracing Method insures precise repayment of tax deferral loans as soon as deferral of income ends. In contrast, under the Current Comparison Method, repayment of tax deferral loans when income deferral ends may not be precise, although underpayments or overpayments bear interest and will ultimately be corrected. The Tracing Method also facilitates the coordination of interest payments with cash receipts from transactions subject to the interest charge, if this is desired. The Current Comparison Method, however, involves a lesser administrative burden in many cases, such as installment sales by dealers and investments in marketable securities. In such cases, this advantage of the Current Comparison Method seems to outweigh the advantages of the Tracing Method. If, however, the only transaction subject to an interest charge to be determined on a current basis is an isolated installment sale, the Tracing Method is to be preferred.

### B. *Lookback Recomputation Method*

#### 1. Transactions Involving Problems of Valuation

In order to apply the Current Comparison Method or the Tracing Method for determining the interest charge, taxable income must be determined under accrual rules. In many cases,

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[146] *See supra* notes 84–88 and accompanying text.

[147] Under either the Current Comparison Method or the Tracing Method, the interest accruing on the deferred tax liability would have to be computed in each year (even if no installment is received) to determine the interest to be deducted currently.

however, this process can be difficult, and such difficulty is at least one of the reasons that tax deferral is permitted. This is true, for example, in the case of determinations of taxable income with respect to income from contingent deferred compensation, changes in the value of nonmarketable capital assets (such as interests in closely held businesses), fees for professional services and profits from incomplete long-term contracts.[148] In such cases, it may be preferable for an interest charge to be determined by use of the Lookback Recomputation Method. Under this method, accrual rules are applied only after a transaction has been completed.[149] As discussed below, a variant of this method is used to determine the interest charge or credit under section 460 of the Code, relating to accounting for long-term contracts.[150]

### 2. Operation of Lookback Recomputation Method

Under the Lookback Recomputation Method, a taxpayer determines his tax liability for each year with the benefit of rules permitting deferral. At the completion of any transaction for which deferral is permitted, the taxpayer recomputes tax liability for each year of the transaction, including the current year, without application of deferral rules to the transaction.[151] Next, the taxpayer compares the recomputed tax liability for each year with the actual tax liability for that year. Any difference between the two[152] is treated as a loan extended by the Treasury to the taxpayer, or as a loan extended by the taxpayer to the

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[148] *See supra* notes 24, 25, 26 & 30 and accompanying text. This is also true of a United States investor's share of earnings of a PFIC that does not provide current earnings information. *See supra* notes 6 & 31 and accompanying text.

[149] *See infra* notes 150–56 and accompanying text.

[150] I.R.C. § 460 (1986). *Cf.* Bradley-Gephardt bill, *supra* note 5, § 414(a) (interest charge with respect to use of the completed contract method). Under the Bradley-Gephardt bill, the interest charge may be determined under the "exact method" or the "simplified method," each to be set forth in Treasury Regulations. The "exact method" appears to be the Lookback Recomputation Method. Under each method, the taxpayer is to allocate "to each taxable year in which activities relating to the long-term contract occur such taxable year's proper share of the net income or loss from the contract." *Id.* Under the "exact method," interest is to be computed on the underpayments or overpayments for prior taxable years that would result solely from such allocation.

[151] If several transactions end in the same year, such a recomputation of tax for a prior year (or the current year) may reflect simultaneously the effect of denying deferral to all such transactions.

[152] The actual tax liability would exceed the recomputed tax liability either because income recognized in that year was earned in a prior year or because a loss that was earned in that year and would have offset income in that year was recognized and deducted in a subsequent year.

Treasury, as the case may be, commencing on the due date of the return for that year.[153]

The taxpayer multiplies the amount of each loan by an interest factor[154] (found in a Treasury table) which reflects the compounding of interest from the due date of the return for the prior year in which the loan was made to the due date of the current year's return. Any interest owed by the taxpayer to the Treasury is netted with any interest owed to him by the Treasury. The taxpayer pays the interest charge with his return for the current year. He deducts the interest charge in determining the current year's tax,[155] unless an after-tax interest factor is used.

Finally, the taxpayer compares the aggregate amount of loans made by the Treasury to him during the transaction to the aggregate amount of loans made by him to the Treasury to determine whether there is any remaining positive or negative loan balance. If such a balance remains, it is also paid at this time.[156]

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[153] *Cf.* I.R.C. §§ 665–668 (1986) (throwback rules with respect to distributions of accumulated income by trust). Accumulated income of a trust is taxed to the trust. Under the throwback rules, subsequent distributions of such income are taxed "roughly as though they had been distributed to the beneficiaries in earlier years, subject to a credit for the taxes paid by the trust when it received the income." B. BITTKER, *supra* note 93, § 81.5.1, at 81-44. Under laws in force from 1969 to 1976, the beneficiary could determine the tax on such distributions under either the "exact" or "shortcut" method. The "exact" method was similar to the Lookback Recomputation Method in that it required the beneficiary to recompute tax for all prior years in which a portion of the accumulated income distributed in the current year had been received by the trust, in order to take into account hypothetical distributions of the accumulated income in the year received by the trust. *See* I.R.C. § 668(b)(1)(A) (repealed in 1976). *See* B. BITTKER, *supra* note 93, § 81.5.4, at 81-51. *See also supra* note 93. Under current law, a somewhat simpler though less accurate method is used to determine the tax on accumulation distributions. This method requires recomputation of tax only for the "three 'middle income' years of the five-year period preceding the year of the distribution." *See* B. BITTKER, *supra* note 93, § 81.5.4, at 81-52; I.R.C. § 667(b) (1986).

No interest charge is imposed upon the tax determined under the throwback rule, except in the case of a foreign trust. *See id.* §§ 667(a)(3), 668. The interest charge for foreign trusts is determined by applying the interest rate of 6% to the tax on the accumulation distribution, multiplied by a fraction. The denominator of this fraction is the number of prior years from which income was accumulated to be distributed in the current year; and the numerator of this fraction is the sum of the number of years of accumulation from each such prior year. *Id.* § 668(a).

[154] The interest factor would be based upon the applicable federal rate. *See supra* notes 41–47 and accompanying text.

[155] The interest charge would also be deducted in determining hypothetical accrual tax liability for the current year. The comparison of actual and hypothetical tax liability for the current year does not enter into the determination of the interest charge, but rather is required only to determine the amount of underpayment or overpayment of the tax deferral loan. For a similar result under the Current Comparison Method, see *supra* notes 88 & 90.

[156] An alternative method of computing the interest charge is for the taxpayer to determine a cumulative loan balance for each transaction (or for all transactions ended

The Lookback Recomputation Method can be illustrated by the example of a contractor who is engaged in the performance of a construction contract from January 1, 1987 through December 31, 1990. The total contract price of $1 million is paid in four equal installments of $250,000 at the close of 1987, 1988, 1989, and 1990. In each of the four years of the contract, $100,000 of costs allocable to the contract are incurred. Assume that the contractor computes his tax liability under the completed contract method and thus defers reporting of his $600,000 profit until 1990. This assumption is not entirely realistic in that under section 460 of the Code only 60% of contract items may be reported under the completed contract method.[157]

When filing his 1990 return, the contractor computes the interest charge as follows: He recomputes tax liability for each of the years 1987 through 1990 under the percentage of completion method (based upon the percentage of total contract costs incurred in each year). In each of the years 1987 through 1989, the taxable income from the contract is $150,000 under the percentage of completion method, as compared with zero under the completed contract method. If the tax rate applicable to this additional income in each of the years 1987 through 1989 would have been 33%, the excess of recomputed tax over tax paid is $49,500 ($150,000 x 0.33) for each such year. The taxpayer would be deemed to have received three separate loans of $49,500 as of April 15, 1988, April 15, 1989, and April 15, 1990.

In 1990, taxable income from the contract is $150,000 under the percentage of completion method, as compared with $600,000 under the completed contract method. Assuming that the additional income under the completed contract method is taxed at a rate of 28%, the excess of the tax under the completed contract method over the tax recomputed under the percentage

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in the same year). This method has the advantage of offsetting a loan made by the Treasury (or the taxpayer) with a loan made by the taxpayer (or the Treasury) in a subsequent year. For an example, see *infra* note 158.

The taxpayer would determine the adjustments to the loan balance as of the end of each year, to reflect interest accrued during the year and additional loans or repayments of loans made as of the end of the year. This method might be more complex for a taxpayer to apply. Under this method the applicable interest rate would be the federal short-term rate applicable to each year that the loan balance was outstanding.

[157] I.R.C. § 460 (1986). *See supra* note 14 and accompanying text. Under the completed contract method, the $400,000 of costs allocable to the contract are deducted only on completion of the contract. *See* JCT PAMPHLET, *supra* note 8, at 45; BLUEBOOK, *supra* note 4, at 524–25, 529. For costs allocable to the contract, see I.R.C. § 460(c) (1986).

of completion method is $126,000 ($450,000 x 0.28). This amount is treated as a loan made by the taxpayer to the Treasury as of April 15, 1991.

Interest is computed on each of the three loans received by the taxpayer by multiplying the loan amount by an interest factor set forth in a Treasury table. Assuming the applicable interest rate in each case is 10%, compounded annually, the interest charge is $16,384.50 with respect to the first loan ($49,500 x 0.331), $10,395 with respect to the second loan ($49,500 x 0.21), and $4,950 with respect to the third loan ($49,500 x 0.10). (No interest is accrued on the loan of $126,000 made to the Treasury since it was made at the time that the 1990 return was filed.) The sum of these interest amounts, or $31,729.50, is paid as an interest charge by the taxpayer with his 1990 return. This interest is deducted by the taxpayer in computing (and recomputing) his 1990 tax liability. In addition to the 1990 tax liability and the interest charge, the taxpayer pays with his 1990 return the remaining positive loan balance of $22,500, i.e., the sum of the amount of loans received, $148,500, less the amount of the loan made by the taxpayer, $126,000.[158]

### 3. Accuracy

a. *Timing of tax payments within a taxable year.* There are potential sources of inaccuracy under the Lookback Recomputation Method. For instance, under this method the period of delay in making tax payments on deferred income is assumed to begin on the due date of the return for the year that the

[158] Under the alternative method of computing the interest charge, *see supra* note 156, the taxpayer would establish a loan balance of $49,500 on April 15, 1988. As of April 15, 1989, he would add to the loan balance two amounts: the interest accrued during 1988, or $4,950, and the additional loan made as of April 15, 1989, or $49,500. Thus, the new loan balance would be $103,950. As of April 15, 1990, he would add to the loan balance two amounts: the interest accrued during 1989, or $10,395, and the additional loan made as of April 15, 1990, or $49,500. Thus, the new loan balance would be $163,845. As of April 15, 1991, he would add to the loan balance the interest accrued in 1990, or $16,384.50. The interest charge would be the sum of the amounts of interest accrued in each year, or $31,729.50. This amount would be deductible.

If the difference between loans received by the taxpayer and loans repaid is to be accounted for, this could be done by subtracting from the final loan balance ($163,845 plus $16,384.50 for a total of $180,229.50), the amount of the interest charge paid ($31,729.50) and the principal repayment in the final year ($126,000). The remaining loan balance of $22,500 would be owed by the taxpayer to the Treasury. It might be simpler to compute this amount by adding together all the loans received and subtracting the loan repayment.

deferred income[159] is earned and to continue to the due date of the return for the year that the income is recognized.[160] However, in some cases, because of the effects of the estimated tax payment rules, deferral of income will cause all or a portion of a tax payment to be delayed either (a) between quarters of the same taxable year[161] or (b) from one quarter of a taxable year to a different quarter of a subsequent taxable year.[162]

Correcting this potential for inaccuracy would be too burdensome for taxpayers. It would require that when a taxpayer is recomputing a prior year's tax, or the current year's tax, in order to determine the interest charge, he must also determine the amount of estimated tax payments, if any, for each quarter with respect to the recomputed tax.[163]

b. *Repayment of remaining loan balance.* Another source of inaccuracy exists if the taxpayer or the Treasury, as the case may be, is not required to pay off any remaining positive or negative loan balance at the completion of the transaction. This is apparently the case under section 460 of the Code, which provides for an interest charge, or credit, with respect to the reporting of income under long-term contracts.[164]

As discussed above, the existence of a loan balance at the completion of a transaction is generally due to a change in the applicable tax rates between the time that deferred income is

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[159] *Cf.* I.R.C. § 1291(c)(3) (1986) (interest charge on United States investor's share of accumulated earnings of PFIC); *see also supra* note 132 and accompanying text (Tracing Method). Under the Lookback Recomputation Method, deferral of a loss is assumed to be for the period from the due date of the return for the year when the loss would be utilized under accrual rules to the due date of the return for the year when the loss is recognized under deferral rules. *See supra* notes 150–53 and accompanying text.

[160] This generalization does not cover cases where there is a net operating loss. *See supra* note 106.

[161] Deferral of income within a single taxable year may affect the size of the required estimated payments for particular quarters of the year under the annualized income installment method. *See supra* note 111 and accompanying text; *see also infra* note 269 and accompanying text.

[162] For example, the tax on an item of income may be subject to estimation if the income is deferred, but not if the income is reported when earned. *See supra* notes 113–14.

[163] *See supra* notes 113–14 and accompanying text.

[164] I.R.C. § 460 (1986). *See infra* note 169 and accompanying text. Apparently, this is also true under the "exact method" for determining the interest charge with respect to use of the completed contract method under the Bradley-Gephardt bill. *See supra* notes 5 & 150.

earned and the time that it is recognized.[165] Even when the difference in tax rates is relatively small, the remaining loan balance may be quite large in relation to the amount of the interest charge.[166] The existence of a loan balance at the completion of the transaction may also be due to a change in the utilization of losses or credits as a result of income deferral.[167]

The completion of the transaction would be a convenient time for the taxpayer to pay any remaining positive balance. However, determination of the amount of any remaining loan balance adds complexity because it requires recomputation of the tax for the final year of the transaction without the benefit of deferral rules.[168] This step is omitted under section 460 of the Code.[169] Yet this complexity is probably not out of proportion to the complexity involved, in any case, in applying the Lookback Recomputation Method.[170] Moreover, recomputation of the tax for the final year is necessary for an accurate determination of the interest charge with respect to subsequently completed transactions that were in progress during that year.[171]

If any remaining loan balance is to be paid at the conclusion of the transaction, then the amount of the taxpayer's loss or credit carryovers should thereafter be deemed equivalent to the amount of carryovers that the taxpayer would have had if the income from the transaction had been reported on an accrual basis.[172]

c. *Deduction of interest charge.* Under the Lookback Recomputation Method, the interest charge cannot be deducted

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165 *See supra* note 104 and accompanying text. It could also be due to a change in applicable tax rates between the time that a deferred loss would be utilized under accrual rules and the time that it is recognized and utilized under deferral rules, or due to an inability to use the deferred loss in the year recognized.

166 In the example in text accompanying *supra* notes 157 & 158, where the taxpayer's applicable tax rate changed from 33% to 28% and interest accrued at a rate of 10% over periods of one to three years, the amount of the remaining loan balance was about 70% of the amount of the accumulated interest charge (before taking into account the deduction for the interest charge).

167 *See supra* note 106 and accompanying text.

168 This step permits the determination of the amount of the loan repayment for the year, which can then be compared with the net loan extensions in earlier years.

169 *See* I.R.C. § 460(b)(3)(A) (1986). It also does not seem to have been contemplated by the Bradley-Gephardt bill. *See supra* notes 5 & 150.

170 As discussed below, much of this complexity could be avoided, at a cost of reduced accuracy, by use of the Shortcut Lookback Method. *See infra* notes 229–30, 237–61, 277–92 and accompanying text.

171 *See infra* notes 214 & 216 and accompanying text.

172 *See supra* note 106 and accompanying text; *see also infra* note 214.

until the completion of the transaction because it is not determined before that time. Deducting the interest charge at the completion of the transaction is less accurate than deducting the interest charge as it accrues.[173] Recomputation of the tax for prior years to permit deduction of the interest charge in the years in which it accrued would be prohibitively complex.

Alternatively, an after-tax interest factor could be determined by reference to either an assumed tax rate or the rate applicable to the deferred income when recognized. If the assumed rate is the highest marginal rate for each year in which the interest charge accrues, then any resulting inaccuracy would not be to the disadvantage of the taxpayer.[174]

### 4. Liquidity

Under the Lookback Recomputation Method, the taxpayer delays, until completion of the transaction, payment not only of the tax on deferred income, but also of the interest charge on the tax. Although liquidity problems are entirely avoided by this approach,[175] this advantage for the taxpayer comes at the expense of the Treasury.

In some cases, difficulty in valuing income currently is the sole justification for permitting income deferral; taxpayers are assumed to have sufficient cash flow to make current tax payments. In such cases, application of a variation of the Lookback Recomputation Method may improve the Treasury's budgetary situation without causing the taxpayer undue hardship.

Under this variation, the taxpayer is required to compute and pay the tax without the benefit of deferral rules, despite the possibility of a mistaken calculation of income. After completion of the transaction, the taxpayer recomputes his tax liability for each year of the transaction with the benefit of hindsight. The difference between the recomputed tax and the actual tax for any prior year[176] bears interest, to be paid or received at the completion of the transaction, for the period until the completion of the transaction. Any discrepancy remaining between aggre-

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[173] *See supra* note 53 and accompanying text.

[174] *See supra* notes 54–55 and accompanying text.

[175] This assumes that the amount of the tax plus the interest charge does not exceed the cash receipts from the transaction. *See supra* note 45 and accompanying text.

[176] The actual tax for a prior year would exceed recomputed tax if too great a profit (or too small a loss) was reported in that year or if a profit was reported although a loss was actually incurred.

gate tax paid and aggregate tax as recomputed would also be paid or received by the taxpayer at the completion of the transaction. Under this method, compensation for errors reflects the time value of money and changes in tax rates or loss utilization, although this does not necessarily mean that errors are entirely harmless to the taxpayer or the Treasury.[177]

This variation of the Lookback Recomputation Method is generally adopted under the 1986 legislation with respect to income from long-term contracts.[178] Under section 460 of the Code, taxpayers must use the percentage of completion method to determine tax liability with respect to 40% (or 100%) of the items under a long-term contract.[179] Upon completion of the contract, the taxpayer recomputes his tax liability for each prior year by applying the percentage of completion method with the benefit of hindsight to 40% (or 100%) of the items under the contract.[180] Errors are compensated for by an interest charge or credit.

Under earlier tax reform proposals, such as the Bradley-Gephardt bill, use of the completed contract method would have been permitted, with deferral compensated for by an interest charge.[181] Congress apparently concluded, however, that since

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[177] For instance, an error to the disadvantage of the taxpayer may reduce his cash flow at a time when his needs for cash are critical; similarly an error to the disadvantage of the Treasury may result in an increase in indebtedness (although temporary) generating a budgetary crisis. *See generally* Halperin, *supra* note 3, at 533 (delayed deduction of larger amount may not be equivalent to smaller immediate deduction if the larger deduction cannot be fully used in subsequent year or if future tax savings are not taken into account to determine if taxpayer has satisfied statutory or regulatory reserve requirements to guarantee taxpayer's ability to meet future liabilities).

[178] I.R.C. § 460(a), (b), *added by* TRA 1986, *supra* note 4, § 804(a). The interest provision is referred to in the statute as the "look-back method." *See* I.R.C. § 460(a)(2) (1986). But under section 460 of the Code, any discrepancy between loan extensions and loan repayments is not corrected at completion of the contract. *See supra* notes 164 & 169 and accompanying text. *Cf.* Land, *supra* note 3, at 300–01, 305 (yield-based approach could be used to correct errors in determining accrued interest on contingent obligations or deductions).

[179] I.R.C. § 460(a)(1), (b)(1) (1986). Under the percentage of completion method expenses are generally deducted when incurred. *See* Treas. Reg. § 1.451-3(c)(3) (1986); BLUEBOOK, *supra* note 4, at 528–29. Gross income from the contract is reported in accordance with the percentage of completion of the contract. The percentage of completion is determined by comparing costs allocated to the contract and incurred before the close of the year with the estimated total contract costs. *See* I.R.C. § 460(b)(2)(A) (1986); *see also* BLUEBOOK, *supra* note 4, at 528–29.

[180] Income under the contract is allocated among taxable years before the year of completion based upon the actual contract price and costs (instead of the estimated contract price and costs). I.R.C. § 460(a)(2), (b)(3)(A) (1986). *See* BLUEBOOK, *supra* note 4, at 528–29.

[181] *See supra* notes 5 & 150. *See also* JCT PAMPHLET, *supra* note 8, at 57–58 (describing tax reform proposals with respect to long-term contracts). A similar proposal

contractors often receive progress payments, they have sufficient cash flow to make current tax payments, at least with respect to 40% of the income from the contract. Congress added the interest provision to address concern of contractors that errors would occur in applying the percentage of completion method.[182]

### 5. Valuation

Under accrual rules, changes in the value of capital assets are determined currently, and the value of a right to receive payment for goods or services is determined in the year the right is earned. Performing such valuations may require considerable time and effort, and the reliability of the results may be uncertain. On the other hand, deferring income until capital assets are disposed of or receivables are collected effectively treats all changes in the value of capital assets as occurring entirely in the year of disposition and effectively treats all receivables as valueless until the time of collection. Such treatment is likely to be inaccurate in the majority of cases. A third alternative available through use of the Lookback Recomputation Method is to determine values with the benefit of hindsight.[183] However, this hindsight determination may prove more helpful in some cases than in others. A few examples will be considered.

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was made by Senator Quayle (R-Ind.). *Id.* However, Representative Stark (D-Cal.) proposed prohibiting use of the completed contract method for long-term contracts with the federal government. Taxpayers engaged in the performance of these contracts would be required to include currently the greater of (1) the amount determined for the taxable year and prior years under the percentage of completion method, or (2) the aggregate amount thus far received in progress payments, less amounts already included in prior years. *Id.* at 57.

[182] *See* HOUSE REPORT, *supra* note 5, at 626, describing the rationale for the interest provision as follows:

> [T]he committee realizes that use of the percentage of completion method may produce harsh results in some cases, for example, where an overall loss is experienced on the contract, or where actual profits are significantly less than projected. The committee believes that, in order to avoid these possible results, it is appropriate to provide that, at the end of a contract, interest be paid to the taxpayer (or to the Federal government) where taxes paid under the percentage of completion method for any year are more (or less) than the taxes that would have been paid if the actual income from a long-term contract were spread over the life of the contract on the basis of actual costs.

Congress was also concerned that the percentage of completion method was "subject to manipulation by taxpayers." *See* BLUEBOOK, *supra* note 4, at 527.

[183] *Cf.* Land, *supra* note 3, at 271, 278–79, 283–86, 304 (until realization, the value of property is assumed to equal its basis, thus avoiding need for valuation; under yield-based approach, the earning of contingent deferred payments, including capital gains, is determined by hindsight).

a. *Professional fees.* For instance, under an ideal accrual system, a professional, such as an attorney, would include in income the value of a receivable in the year in which it was earned by performance. The attorney would determine the value of the receivable based upon a prediction of the amount to be received from the client and the time of receipt. If the receivable is collected in the following year, the attorney would report, in that year, any difference between the amount previously included in income and the amount collected.

Such an appraisal of receivables would be difficult and inconvenient for the taxpayer and is likely to lead to controversy with the Internal Revenue Service because of the significant uncertainties involved. Such uncertainties may relate to: the amount of the fee to be claimed when the fee agreement is open-ended or is subject to contingencies, the possibility of price adjustments resulting from negotiations with clients, and the possibility of delays and defaults by clients. Therefore, if an accrual system is to be implemented, the process of valuation would have to be simplified even at the cost of a reduction in accuracy. For example, a formula based upon prior experience could be used to predict downward price adjustments and defaults by clients[184] despite the possible inaccuracy of such an approach.[185] Valuation of fees could be delayed pending resolution of disputes with clients and of contingencies affecting the amount of the fee payable under the agreement.[186] Due to the difficulty of

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[184] *Cf.* I.R.C. § 448(d)(5) (1986) (for a service provider using an accrual method, accrual is not required for service income that, on the basis of experience, will not be collected in cases where there is no explicit interest charge or penalty for late payment). The amount of a receivable that is not expected to be collected is determined by a formula. Temp. Treas. Reg. § 1.448-2T(e)(1) (1987). It is the amount that bears the same ratio to the receivable outstanding at the close of the year as (a) the total bad debts sustained during the period consisting of the current year and the five preceding years (or, with the Internal Revenue Service's approval, a shorter period), adjusted for bad debt recoveries in that period, bears to (b) the sum of the accounts receivable at the close of such six (or fewer) years. *Id.* § 1.448-2T(e)(1)(i). *See* Blum, *"Accrual" Fate, supra* note 26, at 658–59 & nn.235–37. If a default premium is incorporated in an explicit interest charge, however, then the risk of default is accurately reflected without deducting any addition to a bad debt reserve; instead, bad debts should be deducted when they become worthless. *Id.* at 646–49, 656–58, 662.

[185] 2 TREASURY I, *supra* note 8, at 218; TREASURY II, *supra* note 10, at 215 (such a formula "bears no necessary relationship to the future losses"). *See also* Blum, *"Accrual" Fate, supra* note 26, at 660–61. The TRA 1986 requires that bad debts be accounted for only when they become worthless, except in the case of certain service income and in the case of certain financial institutions. *See supra* note 184; *see also* I.R.C. § 166(a) (1986); TRA 1986, *supra* note 4, § 805(a) (repealing I.R.C. § 166(c)); CONFERENCE REPORT, *supra* note 4, at II-315.

[186] *See* Treas. Reg. § 1.446-1(c)(1)(ii) (1987) (accrual not required before amount of

predicting the time of payment, identification of implicit interest may have to be foregone.[187]

Under the Lookback Recomputation Method, the value of a receivable at the time it is earned is determined only when the fee is collected; such value is assumed to equal the amount that the client eventually pays[188] less interest, implicit or explicit. Since the period of delay in making payment is known, the implicit interest earned in each year that the receivable was outstanding can be determined by reference to the applicable federal rate.[189]

Such hindsight determination of the value of a receivable might not achieve the same result as an appraisal of the receivable based upon the circumstances at the time it is earned. The amount ultimately paid by the client may differ from the expected amount either because of an intervening change in circumstances, such as the onset of a recession, or because the expected value was determined on the basis of a wide range of possible outcomes.[190] Nevertheless, due to the administrative difficulties inherent in the implementation of an accrual system, the hindsight approach may be at least as accurate as an accrual system. Moreover, the hindsight approach would likely be much more accurate than the use of the cash method without an interest charge since that method assumes that the value of any receivable is zero until the time of collection.

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income can be determined with reasonable accuracy). *See* Blum, *"Accrual" Fate, supra* note 26, at 633–37.

[187] *See* Blum, *"Accrual" Fate, supra* note 26, at 639–41. It might be argued that if clients pay the same fee for similar services regardless of the period for which payment of the fee is delayed, then the amount of the implicit interest charge is the same for each client. *See id.* at 603–05. However, determination of implicit interest on this basis would be too difficult. It would require that the average period of delay for all clients be determined. *See id.* at 639–41.

[188] This has the effect of permitting an allowance for bad debts in the year that fees are earned, rather than in the year that the bad debt becomes worthless. Such treatment is appropriate, at least in a case where there is no explicit interest charge. *See supra* note 184.

[189] The Treasury could provide a table setting forth the percentage of a fee collected after a specified number of years that represents implicit interest in each of such years. *See* Land, *supra* note 3, at 286, 295–96 (in applying yield-based approach, the issue price of implicit obligation with respect to contingent deferred payment for services is determined by discounting at market risk-free rate; this approach is based upon the assumption that contingency affects amount earned rather than yield on obligation); Prop. Treas. Reg. § 1.1275-4(c)(3)(ii), 51 Fed. Reg. 12,087 (1986) (in case of debt instrument issued for nontraded property, contingent payment generally treated as principal to extent of present value (determined by discounting at test rate), with remainder of payment treated as interest).

[190] *See infra* notes 191–92 and accompanying text.

However, the hindsight method of valuing receivables may not be appropriate when there is a very wide range of possible fees under a fee agreement, as would be true under a contingency fee arrangement in a personal injury suit. The amount collected by the attorney as his fee in any one case may bear no close relationship to the expected value of the fee at the time the services are performed. Thus, the hindsight method would not appear to be preferable to the cash method.[191] On the other hand, if the taxpayer repeatedly performs services under such arrangements, the aggregate fees received less implicit interest can be expected to equal the aggregate value of the expected fees at the time of performance.[192]

b. *Contingent deferred compensation.* The hindsight approach may also prove useful in valuing contingent deferred compensation. Assume, for example, that an employee is awarded, as a bonus, the right to receive $10,000, with accrued interest, at age sixty-five if he lives to that date. When the bonus is awarded, the actuarially determined probability that he will receive the bonus is 80%.[193] Under accrual rules, the employee would be taxed on $8,000 when the bonus was earned and on additional amounts as his right to the bonus increased in value; if he died prematurely, the amount previously included would be deducted. Although economic income would be accurately measured, the employee might view the inclusion of any amount in income prior to the receipt of the bonus as unfair since he might never collect the bonus.[194]

Under a hindsight approach, the transaction would be accounted for only if and when the bonus was actually received.

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[191] Even if fees were generally determined on an accrual basis, accrual would not be required of a contingent fee. *See supra* note 186 and accompanying text.

[192] For example, assume that an attorney bringing a personal injury suit on behalf of a client agrees to accept as his fee 33.3% of the client's recovery. If there is a 50% chance that the recovery will be $3,000,000 (and the fee $1,000,000) and a 50% chance that the recovery (and the fee) will be zero, the expected value of the fee is $500,000. Under a hindsight approach, the right to receive the fee would, however, be valued at $1,000,000 or zero, depending upon the outcome. Thus, the valuation would be either $500,000 too high or $500,000 too low. Under the cash method, the valuation (i.e., zero) would always be $500,000 too low. If there were many transactions of a similar nature, greater overall accuracy would be achieved by estimating too high in some cases and too low in others than in estimating too low in all cases.

[193] This example is drawn from Halperin, *supra* note 3, at 541.

[194] Halperin explains that "[a]lthough this is analogous to receiving cash compensation of $8,000 followed by the purchase of an annuity contract that might never pay benefits, employees might find it difficult to understand why they should be taxed on money that they might never receive." *Id.*

Thus, an employee who did not receive the bonus would simply disregard the transaction. However, an employee who did receive the bonus would have to determine an interest charge under the Lookback Recomputation Method. This interest charge would be determined by recomputing tax for the year that the bonus was earned, in order to reflect inclusion of the actuarial value of the bonus at that time, and by recomputing the tax for subsequent years in order to reflect increases in the actuarial value of the bonus and the accrual of interest. In this way, an employee who did receive the bonus would be taxed accurately, while an employee who did not receive the bonus would be undertaxed. This application of the hindsight approach would result in greater accuracy than the cash method (under which all employees would be undertaxed.)

If the contingency affecting the receipt of the bonus was not quantifiable in actuarial terms, e.g., a contingency based upon the employee remaining in the service of the company, the employee who received a bonus might be required to recompute the tax for the year the bonus was earned to reflect the amount of the bonus, less interest, actually received. However, this application might be rejected because it would inevitably result in some overtaxation of the employee.[195]

c. *Capital gains.* Use of a lookback approach to determine an interest charge, or credit, has been proposed with respect to capital assets that are hard to value. When a capital asset is sold, the sales price is a measure of the asset's current value. By comparing that current value with the original purchase price, the taxpayer can determine, by hindsight, the net change in the asset's value during the holding period. However, this information does not give any clues as to when during the holding period the change in value occurred, or, in fact, whether there were declines in value later made up by increases.

Proposals to impose an interest charge or credit, with respect to capital gains or losses, respectively, have suggested that a uniform assumption be made as to when the change in an asset's

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[195] Whether that overtaxation would be greater than the undertaxation of the cash method would depend upon the original probability (which may never be known) of the receipt of the bonus.

value has occurred during the holding period,[196] e.g., that it occurred in equal amounts in each year during the holding period or at a constant exponential rate.[197] As acknowledged by those proposing such an interest provision, an interest provision employing this kind of a uniform assumption would be less accurate than accrual taxation based upon annual appraisal since the assumed distribution of appreciation or loss during the holding period may differ from the actual distribution.[198]

If the distribution of gain or loss during the holding period that is assumed, in order to determine the interest charge or credit, is closer to the average than a distribution in which the gain or loss occurs entirely in the last year of the holding period,[199] the interest charge or credit would, on average, be more

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[196] *Cf.* I.R.C. § 1291(a)(1)(A) (1986) (earnings of PFIC deemed to have been derived ratably over United States investor's holding period). *See infra* notes 209–12 and accompanying text.

[197] *See* MEADE COMMISSION REPORT, *supra* note 2, at 133 (it would be "necessary to proceed as if the real gain accrued evenly" over the holding period); Brinner, *Comments*, *supra* note 2, at 154 (more appropriate to assume asset appreciates at constant exponential rate than to assume equal absolute appreciation in each year; necessary to use standard appreciation rate, e.g., 5%); Brinner & Munnell, *supra* note 2, at 15 n.19 (assumption made that gain accrued evenly over holding period); Shakow, *supra* note 2, at 1122–23 ("Unless there are signs that it encouraged abuse, I would favor a simple allocation of gain pro rata over the period the property was held [for purposes of determining a deferred charge with respect to hard-to-value assets]."); Wetzler, *supra* note 2, at 121, 152–53 (interest charge on capital gains would be computed "under certain arbitrary assumptions concerning the rate at which the asset price rose or fell during the holding period"; appendix demonstrates computation of interest charge under assumption that gain accrued arithmetically over the holding period). *See also* Land, *supra* note 3, at 303–04 (under yield-based approach, capital gain or loss is deemed to be earned at constant rate over holding period). *Cf.* I.R.C. § 1023 (1979) (repealed 1980) (pre-1977 appreciation exempted from carryover basis at death is computed in the case of nonmarketable securities by "prorating entire gain uniformly over the holding period"). *See* Wetzler, *supra* note 2, at 122 n.10.

[198] *See* Wetzler, *supra* note 2, at 121–22 (deferral charge would differ from accrual taxation, in part, because "[o]nly by accident would the actual gain accrue in whatever manner must be assumed in computing the deferral charge"); Brinner & Munnell, *supra* note 2, at 15 n.19 (if all gains were made in the early part of holding period, interest charge would be too small, while if all gains were made at the end of the holding period, interest charge would be too great). *See also* BLUEPRINTS, *supra* note 2, at 74 (assumption that "gain occurred equally over the period or that the asset's value changed at a constant rate . . . would be particularly inappropriate in those cases where the basis was changed frequently by inflation adjustments, depreciation allowances, capital improvements, etc."); Andrews, *supra* note 1, at 1148 (assumption that gain accrued evenly would not be accurate); Shakow, *supra* note 2, at 1123 n.38 (simple mechanical rule favored since "all reconstructions of this type are based upon assumptions that will not apply to any particular case"); Warren, *supra* note 2, at 318–19, 322 (similar concerns); Warren, *Comments*, *supra* note 2, at 161 ("preference for accrual taxation where feasible is strengthened by failure of the deferral charge always to give the same results as accrual, particularly in the case of a large gain or loss that accrues over a short period on an asset already held for a long period").

[199] *See* Brinner & Munnell, *supra* note 2, at 15 n.19 (using assumption of even accrual over holding period does not create as serious a problem as it might seem, in part, because "in most cases the gain is made early in the holding period").

accurate than the treatment under present law.[200] For an investor who held several assets over his lifetime, the interest charge or credit might, overall, be quite accurate.[201] Moreover, the introduction of an interest provision would permit a repeal of the current limitation on the deduction of net capital losses (assuming that constructive realization, or carryover, of gains and losses would be required at death).[202] The repeal of this limitation would improve accuracy in the treatment of investors who have net capital losses in excess of unrealized capital gains.[203]

However, the interest charge or credit could be quite inaccurate for an investor who held only a single investment over his lifetime, if the distribution of gain or loss in his holding period did not conform to the distribution assumed for purposes of determining the interest charge. The interest charge would be especially harsh for an investor who derived his gain entirely in the last year of the holding period.[204] In that case, the present law, which imposes no interest charge, is fully accurate. On the other hand, an investor who derived his gain entirely in the first year of his holding period would pay too low an interest charge. The equivalent treatment of these very differently situated investors would be inequitable.

Taxpayers faced with the prospect of an interest charge computed on the assumption of a uniform distribution of gain for all investors might seek to avoid holding assets in situations where gain is likely to accrue relatively late in the holding period.[205] While this practice may reduce the inaccuracy involved and thus reduce inequity, it would represent a distortion of investment decisions.[206]

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[200] *Cf.* Land, *supra* note 3, at 303–04 (assumption that capital gain or loss accrued at constant rate more accurate than assumption that "gain or loss is earned all at once at the time of sale").

[201] *See* Brinner & Munnell, *supra* note 2, at 15 n.19 ("investors who are actually overcharged on one asset will probably be undercharged on others, so that over an investor's lifetime the interest charged will more than average out").

[202] *See* I.R.C. § 1211 (1986).

[203] *See supra* notes 115–16 and accompanying text.

[204] *See* Warren, *Comments*, *supra* note 2, at 161 (described *supra* note 198).

[205] *See* MEADE COMMISSION REPORT, *supra* note 2, at 133 (assumption of even accrual of gain "would be the equivalent of averaging the gains over time, and if the taxpayer felt that this compulsory smoothing procedure was working against his interests, then, to the extent that he could control the timing of realizations, the remedy would lie in his own hands"); Hickman, *supra* note 2, at 246 (taxpayers would "sell and repurchase assets that had not significantly appreciated").

[206] *See* BLUEPRINTS, *supra* note 2, at 74 ("Because a simple time pattern of value change would reflect reality in very few cases, the deferral charge would introduce additional investment distortions."). *But see* Gann, *supra* note 2, at 109, 145 & n.254 (interest charge is "reasonable . . . proxy . . . for direct accrual taxation").

These inaccuracies and distortions of an interest provision are probably less significant, on average, than those created by present law. Nevertheless, it may not be acceptable to introduce the complexity of an interest provision with a view to improving accuracy when the result, in many individual cases, will be much less accuracy than under present law.

d. *Long-term contracts.* A version of hindsight determination of an interest charge or credit is currently employed under section 460 of the Code. Under this section, 40% (or 100%) of the gross income under a long-term contract is taken into account as earned, under the percentage of completion method. Initially, the amount of gross income earned from partial performance during the year is determined based upon estimates, i.e., by multiplying the estimated contract price by the estimated percentage of completion during the year (the ratio of the costs incurred in the year to the estimated total costs). Upon completion of the contract, the allocation of gross income to each prior year is redetermined with the benefit of hindsight; the taxpayer multiplies the actual contract price by the actual percentage of completion for the year (the ratio of the costs incurred in that year to the actual total costs). Discrepancies between the actual tax liability for each prior year and the tax liability for that year as redetermined with hindsight are corrected with an interest charge or credit.[207]

The assumption underlying section 460 of the Code is that the retrospective determination of gross income earned by partial performance (based upon the actual contract price and actual total costs) is more accurate than the initial determination (based upon estimates of the contract price and the total costs). This assumption, however, is subject to challenge as a matter of theory.

It would seem that the value of partial performance as of the end of any year of a contract depends on how much of the job appears at that time to have been completed and what contract price is expected to be received, rather than on how much of the job turns out, in hindsight, to have been completed or what contract price is ultimately received. Although it might later turn out that a contract results in an overall loss for the contractor (because total expenses exceed the contract price), it

[207] I.R.C. § 460(a), (b) (1986). *See* BLUEBOOK, *supra* note 4, at 528–29.

might appear, in the early stages, that an overall profit will be earned. In such a case, it might be said that a profit was made in the early years of the contract, but it was erased by a greater loss in the later years. If another contractor were to assume performance of the contract in its early stages, he should be willing to compensate the first contractor for the portion of the profit apparently earned thus far, less progress payments already received.

However, estimating the total costs to be incurred under an uncompleted contract is difficult and speculative. Thus, in practice, a hindsight determination of the percentage of completion, which is simple and certain in result, may be at least as accurate. Any inaccuracy of the hindsight method would generally be to the detriment of the Treasury, and not the taxpayer, since total expenses are more likely to be unexpectedly high than unexpectedly low.

The certainty of the hindsight method minimizes disputes. Assuming that there is agreement as to what costs are allocable to the contract, the Internal Revenue Service will not challenge the hindsight determination of percentage of completion. Since section 460 of the Code provides that any discrepancy between the initial determination and the determination by hindsight will be compensated for by interest, there is little reason for the Internal Revenue Service to challenge the taxpayer's initial determination, even though the initial determination may have been relatively low.[208]

e. *Income from investment in a PFIC.* Section 1291 of the Code, relating to income from investment in a PFIC, also employs a version of hindsight determination. A United States investor in a PFIC may not be informed of his share of the annual earnings of the PFIC. Thus, under section 1291 of the Code, the United States investor's share of PFIC earnings is

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[208] However, compensation for an error in the taxpayer's favor in the initial determination may not be complete under section 460 of the Code because of the failure to require repayment by the taxpayer of a positive loan balance remaining at the completion of the contract. *See supra* note 164 and accompanying text. Moreover, compensation for errors would not be complete if the interest charge is determined by use of a low interest rate. *See supra* notes 43–44 and accompanying text. The interest rate employed under section 460 of the Code is the federal short-term rate plus two percentage points. I.R.C. § 460(b)(3)(C) (1986). *See supra* note 74 and accompanying text.

For determination of costs allocable to the contract, see I.R.C. § 460(c) (1986). This determination is also required under the completed contract method. *See supra* note 157.

determined by hindsight when a distribution is received or stock of the PFIC is sold. The amount of any "excess distribution"[209] received, or the gain on a stock sale, is treated as having been earned ratably over the investor's holding period for the stock. To the extent that the distribution or gain is treated as earned in prior years, the tax thereon is subject to an interest charge.[210]

The assumption that the investor's share of earnings of the PFIC was derived ratably over his holding period may not be accurate. Nevertheless, Congress apparently believes that such inaccuracy is an acceptable cost of eliminating the economic benefit of deferral from investing in a PFIC. Moreover, a United States investor is permitted to determine the interest charge based upon the actual rate of accrual of earnings if the PFIC elects to provide current earnings information, i.e., if it is a qualified electing fund.[211] A PFIC catering to United States investors might be expected so to elect if United States investors considered this to be advantageous.[212]

### 6. Administrative Difficulties

Application of the Lookback Recomputation Method involves a long series of steps. Taxable income for each year of the transaction is redetermined without the benefit of deferral rules; the tax liability for each year is recalculated; the actual tax and the hypothetical accrual tax liability for each year are compared; the difference between actual and hypothetical tax liability for each year is multiplied by an interest factor; the amounts of the interest charge for each prior year are added together; the excess of hypothetical tax liability over actual tax liability for all prior

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[209] An excess distribution is defined generally as the portion of the distributions during the year in excess of 125% of the average amount received during the three preceding taxable years. I.R.C. § 1291(b) (1986).

[210] I.R.C. § 1291(a), (c) (1986). *See* BLUEBOOK, *supra* note 4, at 1027.

[211] *See* I.R.C. §§ 1293-1295 (1986).

[212] The interest charge with respect to undistributed earnings of a qualified electing fund is determined under the Tracing Method. *See supra* note 132 and accompanying text. Under this method, the deferred tax liability subject to the interest charge is determined by reference to the taxpayer's marginal rate that is applicable to the earnings if included on a current basis. By contrast, when the interest charge is determined under section 1291, the deferred tax liability is determined by reference to the highest rate of tax in effect for individuals (or corporations, as the case may be) for the year in which the earnings are assumed to have been derived. I.R.C. § 1291(c)(2) (1986). *See infra* note 232 and accompanying text. Moreover, in the case of a qualified electing fund, capital gain can be passed through to the investor. *See* I.R.C. § 1293(a)(1)(B) (1986). *See* BLUEBOOK, *supra* note 4, at 1024, 1029. These are additional reasons that the election may be advantageous to United States investors.

years is compared to the excess of actual tax liability over hypothetical tax liability for the current year to determine any remaining positive or negative loan balance; tax liability, actual and hypothetical, for the current year is determined with a deduction for the interest charge, unless the interest factor was based upon an after-tax interest rate.

Determination of the hypothetical accrual tax liability for a prior year covered by the transaction requires that tax records for that year be retained and that the law of that year be applied. This determination may be complex if the tax that would have been imposed under accrual rules is to be precisely determined. Adjustments made to taxable income to reflect the difference between income earned and income actually reported from the transaction in a particular year may result in further adjustments in determining taxable income, such as adjustments in the threshold for deducting certain expenses or in the use of losses or credits.[213] Adjustments made to loss or credit carryovers in determining the accrual tax liability for any year covered by the transaction would have to be taken into account in determining the accrual tax liability for any subsequent year covered by the transaction. The loss or credit carryovers arising from the determination of accrual tax liability for the final year of the transaction would be deemed to be the actual carryovers for purposes of determining actual tax liability in the subsequent year.[214]

Determination of the hypothetical accrual tax liability for prior years covered by a transaction would clearly involve an excessive burden in cases where a transaction spans a long period. For example, application of the Lookback Recomputation Method to gain from a capital asset sold after being held for twenty years would require that the tax liability for each of the prior twenty years be recomputed to reflect the portion of the gain assumed to have accrued in each such year. The calculations involved would be long and complicated. Tax records would have to be retained for twenty years, and the law in effect twenty years ago would have to be applied. Similarly, it would

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[213] *See supra* notes 93–98 and accompanying text.

[214] *See supra* notes 97 & 106 and accompanying text. This result assumes that at the close of the transaction any remaining loan balance arising from the transaction is paid. The taxpayer, by paying the interest charge and any remaining loan balance, has made his tax payments equal, in present value, to the payments that would have been made if deferral of income from the transaction had not been permitted. Therefore, any continuing effects of the deferral of income from the transaction (e.g., smaller loss carryovers than would exist under accrual rules) should be eliminated.

not be practical to use the Lookback Recomputation Method to determine an interest charge for compensation deferred until retirement, unless the recomputation of tax liability were limited to the year that the compensation was earned and did not take into account increases in the value of the right to the compensation in later years.

The application of the Lookback Recomputation Method even to transactions of shorter duration would be quite complicated if similar transactions were repeated frequently. For example, suppose that each year a contractor begins performance of one contract with a duration of four years. Each year, when he completes one contract, the contractor recomputes tax liability for the three prior years and the current year.[215] This means that, over time, each year's tax liability will be recomputed four times (since each year will be the fourth, third, second, and first year of successive contracts). A professional who collects all fees within six months after performing services would be required each year to recompute tax liability for the prior year and the current year. Moreover, if even a single fee collected during the year was earned in the second preceding year, that year's tax liability would also need to be recomputed.

Successive recomputations of tax liability for a particular year involve considerable complications if complete accuracy is desired. Whenever tax liability for a prior year is recomputed to reflect accrual treatment of income from a transaction just completed, the last previous recomputation of that year's tax liability (reflecting accrual treatment of income from transactions previously completed) should be the basis for the new recomputation. This procedure is not indicated by section 460 of the Code. However, it is necessary to insure that recomputations reflect the tax rates that would have applied if all of the taxpayer's income had initially been reported on an accrual basis. If this procedure is followed, the newly determined accrual tax liability for any year should be compared with the most recently determined accrual tax liability for that year, rather than with the actual tax liability, in order to determine the loan extension or repayment for that year with respect to the just completed transaction. Otherwise, a portion of the appropriate interest charge

[215] As discussed *supra* notes 164 & 169 and accompanying text, section 460 of the Code does not appear to require recomputation of the current year's tax, even though this omission means that there is no accounting for a remaining positive or negative loan balance. I.R.C. § 460(b)(3) (1986).

or credit may be paid more than once or may go unpaid.[216] To follow this procedure, records must be retained not only of the original computation of the tax, but also of the most recent recomputation of the tax, for each prior year.

If, as a result of an audit or refund claim, or a loss[217] or credit carryback, adjustments are made to taxable income or credits for a prior year, as to which tax has previously been recomputed under the Lookback Recomputation Method, further complications would ensue. The hypothetical accrual tax liability for the prior year would need to be redetermined. The taxpayer would pay, or be refunded, the difference between the accrual tax liability for the prior year, as last determined,[218] and the accrual tax liability, as redetermined with the audit adjustments or loss carryback. In the case of an audit adjustment or refund claim, interest would be charged or received for the period beginning with the time that the accrual tax liability for the prior year was last determined.

### 7. Treatment of Pass-Thru Entities

a. *Interest charge compensating for deferral.* Determination of the interest charge for a partnership or other pass-thru entity is relatively straight-forward under the Lookback Recomputa-

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[216] Suppose that a contractor's taxable income for 1987, as initially computed, is $100,000. In 1988, a contract partially performed during 1987 is completed. In recomputing tax for 1987, it is seen in hindsight that $10,000 of income reported on completion of the contract in 1988 should have been reported in 1987, so that total recomputed taxable income for 1987 is $110,000. An interest charge for the period from April 15, 1988, to April 15, 1989, is paid on the excess of the tax for 1987 computed With such additional income over the tax for 1987 as originally computed. In 1989, another contract partially performed during 1987 is completed. In recomputing tax for 1987, it is seen in hindsight that $5,000 of income reported on completion of the contract in 1989 should have been reported in 1987. This extra $5,000 of taxable income for 1987 should be added to the $110,000 of taxable income for 1987 determined in the 1988 recomputation since if all income earned in 1987 had been reported initially in 1987, the taxable income for 1987 would have been $115,000. The interest charge determined with the 1989 return and payable for the period from April 15, 1988, to April 15, 1990, should reflect only the excess of the amount of the tax on $115,000 over the amount of the tax on $110,000. The interest charge on the excess of tax on $110,000 over the tax on $100,000 was already paid with the 1988 return.

For a more complete example of the application of the Lookback Recomputation Method to successive transactions, see Appendix.

[217] When tax liability for a particular year, e.g., 1986, is recomputed under the Lookback Recomputation Method, the recomputation might result in a loss being carried back to an earlier year, e.g., 1985. In that case, the hypothetical reduction in tax for 1985 would be reflected in determining the hypothetical tax for 1986.

[218] The difference between the actual tax liability for the year and this hypothetical accrual tax liability would already have been accounted for with interest.

tion Method in cases where tax liability is computed initially with the benefit of deferral. By the time that the tax liability for a prior year is to be recomputed to reflect income earned in that year but reported in a later year, the partnership would have determined to which partners such deferred income is to be distributed. Thus, such income, which is reflected in the recomputed taxable income for the prior year, can be allocated to those partners to whom the income will be distributed (whether or not they were partners in the prior year). In contrast to the Current Comparison Method, the Lookback Recomputation Method avoids the need for complicated adjustments when profit shares of partners change between the year in which the partnership earns the income and the year in which the partnership reports the income for tax purposes.

b. *Interest charge correcting errors in applying accrual rules.* Applying the interest provisions under section 460 of the Code to a partnership or other pass-thru entity would not be difficult in cases where partnership accounting follows tax accounting. The taxable income as initially determined under the percentage of completion method would be allocated in accordance with the partners' profit-sharing ratios for the year. At the completion of the contract, recomputed taxable income for each year would be allocated among the partners in accordance with these same profit-sharing ratios to permit each partner to compute his interest charge. If, however, partnership accounting does not conform to tax accounting, application of section 460 of the Code would be extremely complex.[219]

8. Transactions Not Completed at Death

Under the Lookback Recomputation Method, full compensation for the benefits of deferral with respect to income re-

[219] Section 460 of the Code does not provide any guidance for such a case. I.R.C. § 460 (1986). If partnership accounting is on the completed contract method, the partnership would not determine the division among partners of the profit from the contract until the contract is completed. The partnership would, nevertheless, be required to allocate the taxable income reported under the percentage of completion method among existing partners based upon their current profit-sharing ratios. When a partner retires or the contract is completed, the tax allocations would be adjusted to conform to the actual division of the profits among the partners. At the completion of the contract, taxable income under the percentage of completion method would be recomputed for each year of the contract. The recomputed taxable income for each year would be allocated in the same ratios as the taxable income initially computed for the year. The adjustments in the later years, required to conform tax allocations to the actual division of profits among partners, would also have to be recomputed.

maining deferred as of a taxpayer's death occurs only if (1) the income is recognized by the decedent in his final taxable year, and the tax and interest charge are paid with his final return; or (2) the income is carried forward to the estate or heir for future payment of the tax and interest charge at the time that the transaction is completed.[220]

The first alternative, payment of the tax and interest charge at death, presents the same problems of liquidity and valuation associated with recognition of the income when it is earned. However, the inconvenience and difficulty of valuation may be tolerable if limited to once in a lifetime, i.e., at death.[221] As discussed above, problems of liquidity can be avoided by granting an illiquid estate a postponement, with interest, of the payment of tax and the interest charge.[222]

The second alternative, carrying income forward to the estate or heir for future payment of the tax and interest charge, creates serious administrative difficulties. In order to determine the income remaining to be recognized from a transaction which is incomplete at death, the successor would need to determine the decedent's basis for the asset, or the amounts of income and expenses already reported by the decedent with respect to the transaction.[223] More significantly, to determine the interest charge, the successor must determine the extent to which the decedent underpaid tax in years prior to death as a result of deferring income from the transaction. To do so, at the completion of the transaction, the heir must recompute the tax liability of the decedent (as if deferral had not been permitted) for pre-death years covered by the transaction, and then compare the recomputed tax with the actual tax paid by the decedent for such years.[224] This comparison would require that the heir have access to the decedent's tax records for years prior to death.

The interest charge could be determined by the heir in a simpler manner if the decedent had not been required to report

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[220] *See supra* notes 128–29 and accompanying text. If income has been accelerated as a result of an incorrect estimate of income under the percentage of completion method, this acceleration can be corrected by payment of an interest credit to the decedent at death or to his heir at the completion of the transaction.

[221] *See* Wetzler, *supra* note 2, at 120 (discussed *supra* note 131).

[222] *See supra* notes 130–31 and accompanying text.

[223] *See supra* note 129.

[224] The successor must also recompute his own tax liability, without the benefit of deferral, for post-death years covered by the transaction, and compare this recomputed tax liability with his actual tax liability for those years. This computation would be without the benefit of actual or hypothetical loss or credit carryforwards of the decedent.

income from the transaction prior to his death, e.g., in the case of a long-term contract reported under the completed contract method. The heir could be treated as if he had been the owner of the income from the inception of the transaction.[225] The heir would determine the interest charge by comparing his actual tax liability for each prior year of the transaction to his recomputed tax liability for such year (reflecting the inclusion of the income by him on an accrual basis).

In this way, recomputation of tax liability of the decedent could be avoided. However, the heir might not have had the foresight to retain his own tax records for the years covered by the transaction. Moreover, the result would not be the same as if accrual rules had applied initially, since the heir's tax rate in the years in which the income was earned might differ from the tax rate of the decedent in those years.

For these reasons, the alternative of having the estate or heir succeed to the decedent's obligation to pay tax and the interest charge at the completion of the transaction is not feasible. Therefore, it would be necessary to employ the first alternative, that is, payment of the tax and interest charge at death.

### C. *Shortcut Lookback Method*

The tax deferral loan obtained by a taxpayer enjoying income deferral is generally equal to the amount of tax that would have been imposed on the deferred income in the year that it was earned if deferral had not been permitted.[226] Under the Lookback Recomputation Method (as well as the Current Comparison Method) this amount is determined by recomputing the tax liability for the year in which the deferred income was earned so as to include such income, and then by comparing this re-

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[225] The approach of treating the income as if it had belonged to the successor from the beginning of the transaction would not be helpful in cases, such as long term contracts governed by section 460 of the Code, in which the decedent had already reported income from the transaction.

[226] This statement is not necessarily true in a case where, in the absence of deferral, a loss would have offset the income in the year earned so that no tax would have been imposed. *See infra* note 237.

computed tax liability with the actual tax liability for the year.[227] The tax paid with respect to the deferred income in the year recognized (i.e., the loan repayment) is compared with the amount of the tax deferral loan, and any underpayment or overpayment is corrected.[228]

Under the Shortcut Lookback Method, the amount of the tax deferral loan is determined without recomputing the tax for the year in which the deferred income was earned. The amount of the tax deferral loan is assumed to equal the tax that is imposed on the deferred income in the year in which it is recognized.[229] Alternatively, the tax deferral loan is assumed to equal the tax on the deferred income determined by application of an assumed tax rate.[230] No attempt is made to determine if the tax deferral loan is underpaid or overpaid.

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[227] The interest charge under the Lookback Recomputation Method can be expressed as

$Ak(1 + it)^n - Ak$, or

$Ak[(1 + it)^n - 1]$, where

(1) A is the amount of the deferred income earned in a prior year but reported in the current year,
(2) k is the marginal tax rate that would have applied to the income in the year earned,
(3) n is the number of years that the income is deferred,
(4) (1-t) is the marginal tax rate applicable to the deduction of the interest charge in the years that the interest charge accrues. It is assumed that an after-tax interest rate is used to compute the interest charge or that the interest charge is deducted in each year in which it accrues.

[228] The amount of the tax deferral loan is Ak. The tax payment with respect to the deferred income is Ap, where p is the marginal tax rate applicable to the income when recognized. Under the Lookback Recomputation Method, if Ap does not equal Ak, then any excess of Ap over Ak is refunded by the Treasury, and any excess of Ak over Ap is paid by the taxpayer. Thus, the total (net) payment by the taxpayer to the Treasury is

$[Ak(1 + it)^n - Ak] + Ak$, or

$Ak(1 + it)^n$.

[229] In that case, the interest charge is

$Ap(1 + it)^n - Ap$.

The tax plus interest charge is

$Ap(1 + it)^n$.

[230] If an assumed tax rate is used to determine the interest charge, the interest charge is

$Aq(1 + it)^n - Aq$, where q is the assumed tax rate.

Section 453C(e)(4) of the Code employs a form of the Shortcut Lookback Method to determine an interest charge with respect to use of the installment method by certain taxpayers. Under this provision, the tax deferral loan is assumed to equal the tax actually paid with respect to any installment received after the year of sale.[231] Section 1291 of the Code uses another form of the Shortcut Lookback Method to determine an interest charge with respect to a United States investor's share of accumulated earnings of a PFIC. Under section 1291 of the Code, an assumed tax rate is used (the "highest rate of tax in effect" for the year that the earnings were derived) to determine the amount of deferred tax to be paid and the interest charge thereon.[232]

Proposals advocating an interest charge or credit with respect to capital gains and losses have also adopted the Shortcut Lookback Method. Under some of these proposals, the tax deferral loan is determined by multiplying the deferred gain by an assumed tax rate.[233] Under other proposals, a further variation of the Shortcut Lookback Method is used.

Under this variation, the deferred income is multiplied by an after-tax interest factor. The resulting interest amount (as well as 100% of the deferred income) is included in income in the year that deferral ends.[234] The tax liability for that year, thus,

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If the assumed tax rate is also used to determine the tax liability with respect to the deferred income, the tax plus interest charge would equal

$$Aq(1 + it)^n.$$

If not, the tax liability would be Ap (*see supra* note 228), and the tax plus interest charge would equal

$$Aq(1 + it)^n - Aq + Ap.$$

[231] *See* I.R.C. § 453C(e)(4)(B) (1986) ("interest shall be paid on the portion of any tax for any taxable year . . . which is attributable to the receipt of payment on such obligation in such year").

[232] *See* I.R.C. § 1291(c)(2), (3) (1986).

[233] *See* Wetzler, *supra* note 2, at 122, 152–53 (uniform tax rate used to determine both an after-tax interest rate and the amount of the tax deferral loan); Brinner, *Comments*, *supra* note 2, at 154–55 (Wetzler's use of 30% tax rate is a reasonable approximation). *See also* Shakow, *supra* note 2, at 1122–23 & n.38 (tax rate in year of sale or "fixed rate, at or near the maximum marginal rate for individuals," might be used to compute both tax and interest charge on deferred capital gains).

[234] *See* Brinner & Munnell, *supra* note 2, at 16 (proposal to impose deferral charge on capital gains by including more than 100% of the gain in income at the time of recognition). Based on the assumption that the gain accrued evenly in the holding period and the use of a 50% tax rate to determine an after-tax interest factor, the authors construct a table setting forth the "inclusion percentage" for assets with varying holding periods. For a similar approach, see Shakow, *supra* note 2, at 1122–23 & n.38 (IRS could provide table telling taxpayer what percentage of gain to include in income, based upon holding period).

incorporates the interest charge.[235] Under the Bradley-Gephardt bill, taxpayers have the option of using a form of the Lookback Recomputation Method or this "simplified method" to determine an interest charge with respect to use of the completed contract method.[236]

### 1. Accuracy

a. *Tax rate used to measure the tax deferral loan.* If the tax rate used under the Shortcut Lookback Method to measure the tax deferral loan differs from the tax rate that would have applied to the deferred income in the year that it was earned,[237] the Shortcut Lookback Method does not accurately measure the amount of the loan. The interest charge will therefore be too high or too low.

Under section 453C(e)(4) of the Code, the interest charge is determined by use of the tax rate applicable to the deferred income when recognized.[238] This method is inaccurate whenever this tax rate differs from the tax rate that would have applied to the income if it were reported in the year earned. These tax

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[235] The sum of the tax and the interest charge is equal to

$y[A(1 + it)^n]$, or

$Ay(1 + it)^n$

where y is the tax rate that would apply if $A(1 + it)^n$, rather than merely A (the amount of the deferred income), is reported in the year that deferral ends.

[236] *See supra* notes 5 & 150. Under the simplified method, the deferred income or loss is allocated to the year in which it was earned. Interest reflecting the period of deferral is then determined on that amount. The interest rate used is 70% of the interest rate on underpayments of tax. (This interest rate is presumably intended to represent an after-tax interest rate.) Such interest is then added to the taxpayer's income for the current year. Bradley-Gephardt bill, *supra* note 5, § 414(a).

Under the Bradley-Gephardt bill, the inclusion of the "interest amount" is separate from the inclusion of the deferred income. By contrast, under the proposal by Brinner & Munnell, *supra* note 2, at 16 (discussed *supra* note 234) the procedure is to include in income more than 100% of the deferred income (that is, deferred income plus the interest amount).

[237] However, in cases where the income, if reported when earned, would be offset by a loss, the appropriate tax rate to measure the tax deferral loan is zero only if the loss is not utilized, with the income deferred. If, despite deferral of the income, the loss is utilized in a subsequent year, the tax rate measuring the tax deferral loan is the tax rate at which the income offset by the loss would have been taxed absent the loss offset. *See supra* note 106.

If the deferred item is a loss, the appropriate tax rate to measure the tax acceleration loan is the tax rate applicable to income offset by the loss in the year that the loss would be utilized under accrual rules.

[238] I.R.C. § 453C(e)(4)(B) (1986).

rates may differ because of changes in the rate schedule or changes in the amount of the taxpayer's other income[239] (or in the availability of loss offsets)[240] between these two years.[241]

By contrast, under the simplified method, there may be inaccuracy in determining the interest charge even if the applicable rate schedule is unchanged and the amount of other income (and availability of loss offsets) is the same in the year of recognition as in the year of earning the deferred income. Under the simplified method, the tax rate used to determine the tax deferral loan is not the tax rate that applies to the deferred income when recognized;[242] instead, it is the possibly higher tax rate that would be applicable, in the year that the deferred income is recognized, to a hypothetical amount of additional income stacked on top of all of the income reported in that year,

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[239] Applicable tax rates may also change as a result of the taxpayer attaining age 14 during the period of deferral (*see supra* note 104), or because the taxpayer is married or divorced.

[240] As discussed *supra* note 237, the tax rate that would have applied to the income (if reported in the year earned) would be zero, and the amount of the tax deferral loan would be zero, if the income would have been offset in that year by a loss that is not utilized with the income deferred. Under the method described in I.R.C. § 453C(e)(4) (1986), whenever the deferred income is not taxed in the year recognized due to use of a loss or credit, the tax rate used to determine the amount of the tax deferral loan (and thus the amount of the interest charge) is zero.

[241] The potential inaccuracy of the method employed in I.R.C. § 453C(e)(4) (1986) can be illustrated by an example. Suppose, as described *supra* notes 89–90 and accompanying text, an investor sells a parcel of land on January 1, 1987, at a gain of $100,000 with payment to the seller to be made on January 1, 1990. The sale is reported on the installment method. The tax rate applicable to the gain in 1990 is 28% so that the tax attributable to the gain is $28,000. The tax rate that would have applied to the gain if it had been recognized in 1987 is 33%. The applicable interest rate is 10%, compounded annually.

Under the Lookback Recomputation Method, the interest charge would be determined by multiplying the $33,000 difference between (a) the tax that would have been paid in 1987 if the gain had been recognized in that year and (b) the tax actually paid in 1987, by the interest factor of 0.331, for a total interest charge of $10,923. If the tax rate applicable to the deduction of the interest charge in 1990 is 28%, the after-tax cost of the interest charge would be $7,864.56. (Note that it would be more accurate for the interest charge to be deducted in each year in which it accrued.) In addition, the taxpayer would be required to pay the remaining loan balance of $5,000 (the excess of the tax that would have been paid on the gain in 1987 if the gain had not been deferred over the tax paid on the gain in 1990).

Under the Shortcut Lookback Method, as employed in I.R.C. § 453C(e)(4) (1986), the interest charge would be determined by multiplying the tax paid on the gain in 1990, $28,000, by the interest factor of 0.331. The interest charge would be $9,268, or $1,655 less than under the Lookback Recomputation Method. If the tax rate applicable to the deduction of the interest charge in 1990 was 28%, the after-tax cost would be $6,672.96, or $1,191.60 less than under the Lookback Recomputation Method. Moreover, in contrast to the result under the Lookback Recomputation Method, there would be no payment required of the $5,000 remaining loan balance.

[242] This distinction is not drawn by Shakow in his discussion of the simplified method. *See* Shakow, *supra* note 2, at 1122–23 & n.38.

including the deferred income. This additional income is equal to the amount of the deferred income multiplied by the appropriate interest factor. Particularly when the period of deferral is long (and thus the interest factor is relatively large), the simplified method poses a greater risk than the method employed under section 453C(e)(4) of the Code that too high a tax rate[243] will be used to determine the interest charge.[244] Thus, taxpayers may be dissatisfied with a requirement of using this method.

Use of an assumed tax rate to determine the amount of the interest charge also will not be accurate for all transactions. If the highest rate in effect for each year is used, as under section 1291 of the Code,[245] the interest charge will be excessive if a lower rate of tax (or no tax)[246] would have applied to the deferred income if reported when earned. (In the case of section 1291 of the Code, this strict approach may be justified by the taxpayer's opportunity to compute the interest charge under the more accurate Tracing Method by investing in a PFIC that is a qualified electing fund.) On the other hand, if the lowest rate in effect for the year (15% under present law)[247] is used, an individual would generally not pay an excessive interest charge. However, many (perhaps most) individuals would pay too small an interest charge. Moreover, in many cases where an interest credit is due to an individual, such credit would be too small.

Regardless of the tax rate used to determine the interest charge, the Shortcut Lookback Method is inaccurate in failing to correct underpayments or overpayments of the tax deferral loan. Under both section 453C(e)(4) of the Code and the simplified method, as under present law, the tax liability with respect to the deferred income is determined by reference to the tax rate applicable in the year that the deferred income is recognized. Thus, there is an underpayment or overpayment of the

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[243] *See* I.R.C. § 453C(e)(4)(B) (1986). Moreover, the inclusion of the additional amount in income in the year of recognition may result in an unwarranted decrease in the amount of a loss or credit carryback or carryover from that year.

[244] There will also be a smaller risk that too low a tax rate will be used to determine the interest charge.

[245] *See* I.R.C. § 1291(c) (1986). If the "highest rate in effect" for individuals refers to the top 28% bracket, the interest charge will be too low in cases where the top marginal rate of 33% would have applied to the deferred income in the year earned.

[246] This situation would occur in a case where the income, if reported when earned, would have been offset by a loss that is not utilized with the income deferred. *See supra* notes 237 & 240 and accompanying text.

[247] *See* I.R.C. § 1 (1986). *But see supra* note 246 and accompanying text (possibility of zero rate).

tax deferral loan whenever this rate differs from the tax rate that would have applied to the deferred income in the year it was earned. This aspect does not distinguish these methods from present law,[248] but does make them less accurate than accrual taxation. Under the variation of the Shortcut Lookback Method employed in section 1291 of the Code,[249] the deferred income is taxed at the highest rate in effect in the year in which the income is deemed to have been earned; in this way, the possibility of any underpayment is generally avoided, while the possibility of overpayment is increased.[250]

The Shortcut Lookback Method, as exemplified in section 453C of the Code and in the simplified method, does not fully eliminate the tax savings from deferring income to years of lower tax rates. Thus, the incentive for such deferral, under present law, would persist under these methods.[251] It might be argued that this is not a defect, i.e., that taxpayers should be given the opportunity for averaging by deferring income to years in which tax rates are lower.[252] But the theoretical basis for averaging rules (that a taxpayer whose income fluctuates from year to year should pay the same tax as an otherwise similarly situated taxpayer whose income is uniform from year to year) is subject to challenge.[253] Moreover, even if averaging is appropriate, it

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[248] *Cf.* Land, *supra* note 3, at 293 (failure under yield-based approach to use tax rate applicable to income in year earned may be acceptable since "that type of rate differential" is also a feature of current law).

[249] *See* I.R.C. § 1291 (1986). *See supra* note 232 and accompanying text. *See also supra* note 233 (use of assumed tax rate to determine deferred tax as well as interest charge).

[250] If the highest rate in effect for individuals is considered to be 28%, there is still the possibility of an underpayment if the marginal rate of 33% would have applied to the deferred income when earned. *See supra* note 245.

[251] *See* Shakow, *supra* note 2, at 1123 (if tax and interest charge with respect to capital gains is determined by reference to taxpayer's marginal rate in year of purchase or sale, taxpayers could be induced to distort their economic behavior; nevertheless, author recommends use of the tax rate applicable in the year of sale). Lower rates during retirement have been a major impetus to deferred compensation agreements. *See* M. CHIRELSTEIN, *supra* note 11, § 11.01(b), at 213 (deferred compensation may be used as "ad hoc averaging device"); Halperin, *supra* note 3, at 542, 549. *But cf.* Land, *supra* note 3, at 293 (failure to take into account changes in applicable tax rates in determining compensation for tax deferral with respect to contingent payments "may not generate much tax-motivated behavior").

[252] *See* Halperin, *supra* note 3, at 542, 548–49 (special tax on investment income of deferred compensation plans preferable to full accrual taxation since latter but not the former would eliminate the opportunity for averaging by shifting income to retirement years).

[253] *See* Schmalbeck, *Income Averaging After Twenty Years: A Failed Experiment in Horizontal Equity*, 1984 DUKE L.J. 509, 546–47. The chief argument in favor of the statutory averaging provisions that were repealed in 1986 (I.R.C. §§ 1301–1305, *repealed by* TRA 1986, *supra* note 4, § 141) is that horizontal equity requires that "taxpayers

should be available to all taxpayers on an equal basis[254] rather than only to taxpayers in a position to engage in transactions eligible for deferred income reporting.[255]

These inaccuracies of the Shortcut Lookback Method would be much less under the new rate schedules adopted in 1986 than under the rate schedules previously in effect. Under the new schedule, there are only three rates (15%, 28%, or 33%) that generally apply to income of individuals.[256] The range of possible tax rates is still fairly large in that the top rate is more than twice as high as the bottom rate. Moreover, there is a fourth rate of zero, which might be applicable in the year in which the

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whose incomes over a five-year period are equal . . . be taxed equally, regardless of the distribution of income among the five years in the period." Schmalbeck, *supra*, at 576–77. But Schmalbeck argues that "a progressive tax will not necessarily tax excessively taxpayers whose income fluctuates, if their tax is measured—as it should be—in terms of utility sacrifice rather than in terms of dollars." *Id.* at 577. He argues that "an annual period appears to be more satisfactory in most cases" for the assessment of utility sacrifice "than any particular multiyear period." He then concludes that "even if the multiyear viewpoint is correct," the statutory averaging provisions were "seriously flawed" because they provided "only sporadic relief for fluctuation penalties." *Id.*, at 557, 577. For legislative history of the repeal of income averaging, see SENATE REPORT, *supra* note 4, at 45 (income averaging unnecessary in light of flatter rate structure; repeal eliminates complex computations and controversies with IRS regarding status as self-supporting).

[254] *But cf.* SENATE REPORT, *supra* note 4, at 45 (reasons for repeal of statutory averaging provisions); *supra* note 253.

[255] It might be argued that it is more appropriate to apply progressive rates to income in the year it is spent than in the year it is earned. *See* Andrews, *supra* note 1, at 1176 ("rate effects of a consumption- type tax" are more appropriate than those of an income tax since progressivity is designed, at least, in part, to take into account differences between taxpayers' standards *See also id.* at 1175–77. However, this argument, if valid, does not indicate whether deferred income should be taxed at rates applicable in the year earned or at rates applicable in the year recognized. Under our tax system, income that is taxed currently is not necessarily spent; and income that is deferred is not necessarily saved because, except in the case of installment sales, deferred income may be received in cash by borrowing. Even if deferred income is saved during the period of deferral, it is not necessarily spent in the year that deferral ends.

Instead, this argument goes to the basic question of whether an income tax or consumption tax is preferable. The 1986 legislation has moved our tax system closer to the income tax model and an interest charge on deferred income is a further step in that direction. Under an income tax, consistency is achieved only by taxing all income at rates applicable in the year it is earned.

It is also worth noting that the current rate schedule departs from the concept of progressivity to some extent, since in some cases an additional dollar of income is taxed at a lower marginal rate than the previous dollar of income as a result of the phaseout rules. *See infra* note 256.

[256] See I.R.C. § 1, *amended by* TRA 1986, *supra* note 4, § 101(a). The 33% rate results from the phaseout of the 15% rate and of personal exemptions. *See* I.R.C. § 1(g) (1986). For a joint return with one dependent, the 33% rate applies to taxable income from $71,900 to $182,500; for a single return with no dependents, it applies to taxable income from $43,150 to $100,760. Individuals subject to alternative minimum tax pay tax at a rate of 21%. *Id.* § 55(a), (b). The phaseout of the allowance of $25,000 of passive losses from actively managed real estate between $100,000 and $150,000 of adjusted gross income, *see* I.R.C. § 469(i)(3) (1986), creates additional marginal tax rates.

income is earned or is recognized as a result of the use of losses or credits.[257] The amount of taxable income subject to the bottom rate of 15%, however, is relatively small[258] and the zero rate usually will not apply. The extent of the variation in corporate rates is similar, but somewhat greater.[259]

With this new rate schedule, the inaccuracy of the Shortcut Lookback Method may be considered tolerable (as suggested by its use in sections 453C(e)(4) and 1291 of the Code).[260] In most contexts, the greater accuracy achieved by determining the interest charge under the Lookback Recomputation Method may not seem to justify the greater administrative difficulties entailed thereby.

Payment of too little interest by the taxpayer to compensate for tax deferral under the Shortcut Lookback Method is more accurate than payment of no interest compensating for tax deferral, under present law. The potential for overpayment of interest may be minimized in various ways. If the interest charge is determined by reference to the tax rate applied in the year in which deferred income is recognized (as under section 453C of the Code and the simplified method), taxpayers may be able to structure transactions to avoid overpayment of interest. Taxpayers can be given the option of using a more accurate method to determine the interest charge (or of paying the tax currently, in some cases). Moreover, the Shortcut Lookback Method can be applied by use of a low assumed tax rate.

The failure to correct underpayment or overpayment of the tax deferral loan makes the Shortcut Lookback Method less accurate than accrual taxation. Nonetheless this failure does not make the Shortcut Lookback Method (as exemplified by section

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[257] *See supra* notes 237 & 240 and accompanying text.

[258] This amount is $29,750 in the case of a joint return and $17,850 in the case of an unmarried individual's return. I.R.C. § 1(a), (c) (1986).

[259] In case of a C corporation, the first $50,000 of income is taxed at a rate of 15%, and the next $25,000 of income at a rate of 25%. Income in excess of $75,000 is taxed at a rate of 34%, except that income between $100,000 and $335,000 is taxed at a rate of 39%. *Id.* § 11(b). Thus, there is a greater disparity between the lowest and the highest rate. In addition, there is a larger amount of income subject to the lowest rate.

[260] *See id.* §§ 453C(e)(4), 1291 (1986). These provisions, however, have very limited application. Moreover, other options are available to the taxpayer. By investing in a PFIC that is a qualified electing fund, the taxpayer can use the more accurate Tracing Method, instead of the Shortcut Lookback Method, which is employed under section 1291 of the Code. *See supra* note 212 and accompanying text. In lieu of determining the interest charge under section 453C of the Code, a dealer in residential lots or time shares can apply the "proportionate disallowance" rule, as must other taxpayers. *See supra* note 4.

453C of the Code and the simplified method) any less accurate than present law. If, however, an assumed tax rate is used to determine the tax on deferred income, there is the possibility of lesser (or greater) accuracy than under present law.

The problem of inaccuracy under the Shortcut Lookback Method may become more serious, however, if future tax legislation introduces greater variation in the individual (or corporate) rate schedule, e.g., by adding a third individual tax bracket above the 28% bracket. Moreover, if the Shortcut Lookback Method is applied by reference to the tax rate for the year that income is recognized, a major increase in tax rates will have harsh effects on transactions begun prior to the rate increase.

While the Shortcut Lookback Method has these additional sources of inaccuracy not found under the Lookback Recomputation Method,[261] it also shares the sources of inaccuracy present under the Lookback Recomputation Method.

b. *Deduction of interest charge.* Under the Shortcut Lookback Method, as under the Lookback Recomputation Method, the interest charge may not be deducted until the close of the transaction or receipt of cash, since it is not determined until that time.[262] This is less accurate than deduction of the interest charge in the year in which it accrues.

An alternative approach would be to use an after-tax interest rate. To avoid any disadvantage to taxpayers, the after-tax interest rate could be based upon the highest marginal tax rate for each year in which the interest charge accrues.[263]

If an assumed tax rate is used to determine the amount of the tax deferral loan, it might seem desirable to use this same rate to establish an after-tax interest factor.[264] If the assumed rate is too high for both purposes (or too low for both purposes), then

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[261] A further inaccuracy is present under the Shortcut Lookback Method. The amount of the loss or credit carryovers to the year after that in which the deferred income is recognized cannot be adjusted to reflect the use of losses or credits under accrual rules, since the extent of such use would not have been determined. *Cf. supra* notes 172 & 214 and accompanying text.

[262] *See* I.R.C. § 453C(e)(4)(B), (C) (1986) (interest charge deductible in taxable year in which installment is received for purposes of computing tax payment, but not for purposes of determining interest charge).

[263] *See supra* notes 53–55 and accompanying text.

[264] *See* Wetzler, *supra* note 2, at 152–53 (assumed tax rate used both to determine an after-tax interest rate and to determine amount of tax deferral loan).

inaccuracies would tend to be offsetting.[265] It is also possible, however, that the assumed tax rate may be too high for one purpose and too low for the other.[266] In that case, use of the same tax rate for both purposes would make errors cumulative, rather than offsetting.

c. *Timing of tax payments within a taxable year.* Under the Shortcut Lookback Method, as under the Lookback Recomputation Method, the period of delay in making tax payments as a result of income deferral is assumed to run from the due date of the return for the year that the income is earned to the due date of the return for the year that the income is recognized. This assumption may lead to inaccuracy because it fails to take into account the varying extent to which estimated installments are required and the potentially varying size of installments required during the year.[267] This inaccuracy cannot be corrected under the Shortcut Lookback Method. Since no determination is made of the tax liability that would have been incurred if the deferred income had been reported when earned, it cannot be known to what extent that liability would have been paid in (equal or unequal) estimated installments.

Under section 453C(e) of the Code, the period of deferral is assumed to extend from the date that the installment gain is earned (the date of sale) to the date that the gain is recognized (the date that the installment is received).[268] While this method of measuring the period of tax deferral in terms of days (rather than years) has the appearance of greater precision, it is not necessarily any more accurate and may indeed be less accurate.

There is not a close relationship, in terms of days, between the period for which recognition of income is deferred and the

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[265] The higher the tax rate used to determine the tax deferral loan, the greater the amount of the interest charge. The higher the tax rate used to determine the after-tax interest rate, the lower the amount of the interest charge. Thus, the inaccuracy of using too high (or too low) a rate for one purpose would be in the opposite direction to (and would tend to offset) the inaccuracy of using too high (or too low) a rate for the other purpose.

[266] The tax rate appropriate for determining the amount of the tax deferral loan is the rate that would have been applied to the income in the year earned. The tax rate appropriate for deducting the interest charge is the rate or rates that would have applied to the deductions in the years that the interest charge accrued. These rates may differ because the interest charge would not begin to accrue until the year following that in which the income was earned, and the interest charge may accrue over a number of years.

[267] *See supra* notes 110–14 & 161–62 and accompanying text.

[268] I.R.C. § 453C(e)(4)(B) (1986).

period for which *tax payments* are deferred. Generally, the tax on an additional dollar of income recognized within a particular quarter of the year will not be payable entirely at the end of that quarter. Rather, it will be paid in estimated installments at the end of that quarter and succeeding quarters of the year, or in equal estimated installments at the end of each quarter,[269] or on the due date for filing the tax return to the extent that estimated tax payments are not required. Moreover, the particular day within a quarter on which income is received has no significance for the timing of the tax payment.

There is another inherent flaw in the determination of the period of tax deferral under the Shortcut Lookback Method. In some cases, deferred income, if reported in the year earned, would have been offset by a loss that, under deferral rules, is utilized in a subsequent year. In these cases, the tax deferral loan arises not at the end of the year when the income is earned, as is assumed under the Shortcut Lookback Method, but instead at the end of (or during) the year that the loss is utilized.[270]

### 2. Liquidity

Under the Shortcut Lookback Method, as under the Lookback Recomputation Method, taxpayers delay paying not only the tax on deferred income, but also the interest charge on the

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[269] Generally, estimated tax payments are made in four equal quarterly installments. *See supra* note 111. However, the taxpayer also has the option of using the annualized income installment method to determine estimated tax payments for each quarter commensurate with the rate at which income is received through the end of that quarter. *See* I.R.C. §§ 6654(d)(2), 6655(d)(3) (1986). *See also* I.R.S. Form 2210 and Instructions (1987) (including Annualized Income Installment Worksheet). This is more favorable than paying equal installments only if income is received at a slower rate early in the year than later in the year. Moreover, taxpayers eligible to use this method may choose not to do so in order to avoid the need for determining quarterly earnings.

The application of the annualized income method is illustrated by the following example. Assume that a taxpayer receives income at a rate of $3,000 per month throughout the year for a total taxable income of $36,000; assuming a flat tax rate of 10%, his tax liability is $3,600. Estimated tax payments would be made in four equal installments of $810 ($3,600 tax multiplied by 0.90 and divided by 4); the remaining $360 in tax would be paid with the year's return. If the taxpayer were to receive an additional $3,000 in each of April and May (the two months included in the second quarter), he would benefit from determining his first quarter estimated tax payment under the annualized income method; this is because income was received in the first quarter at a slower rate than income was received for the remainder of the year. The quarterly estimated installments would be $810, $1080, $945 and $945. Thus, the additional tax of $600 that was incurred as a result of the receipt of additional income in the second quarter would be payable, in part, in the second, third and fourth quarters, and, for the remaining amount ($60), with the return for the year.

[270] *See supra* notes 106 & 237 and accompanying text.

deferred tax, until completion of the transaction or receipt of cash.[271] Thus, liquidity problems are completely avoided, though at the expense of aggravating the Treasury's cash flow problems. In cases where taxpayers have sufficient cash flow to make current tax payments, the Shortcut Lookback Method can be modified (like the Lookback Recomputation Method) so that current tax payments are required and an interest charge or credit is used to correct errors made in determining such tax payments.[272]

### 3. Valuation

The Shortcut Lookback Method, like the Lookback Recomputation Method, offers the opportunity for a hindsight valuation of income. The usefulness of such a valuation is examined in connection with the Lookback Recomputation Method.[273]

### 4. Pass-Thru Entities

Application of the Shortcut Lookback Method to a partnership or S corporation would not involve special difficulties. As under present law, when the partnership recognizes deferred income for tax purposes, it would allocate it among partners in accordance with their profit-sharing ratios for the year.[274] The partnership would notify each partner of the number of years for which various items of income included in his distributive share had been deferred. In this way, each partner could compute his own interest charge with respect to income allocated to him. Under the approach employed in section 453C(e)(4) of the Code, he would do so by multiplying the tax paid by him on such deferred income in the year it is included in income by

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[271] Under I.R.C. § 453C(e)(4) (1986) (imposing an interest charge with respect to certain installment sales), the tax and interest charge are payable with respect to each installment as it is received.

[272] For example, if this approach were applied to long-term contracts, taxpayers could determine tax liability initially under the percentage of completion method. When the contract is completed, taxable income (but not tax liability) for each prior year of the contract would be recomputed. The amount of deferred or accelerated tax with respect to each prior year would be determined by multiplying the additional taxable income (or reduction in taxable income) for each prior year by the marginal tax rate for the current year or by an assumed tax rate.

[273] *See supra* notes 183–212 and accompanying text.

[274] If the income is not deferred under the partnership's internal accounting method, the allocation would be made in accordance with the profit-sharing ratios used in prior years to determine the partners' shares of such income.

an interest factor based upon the period of deferral.[275] Under the "simplified" method used in the Bradley- Gephardt bill, the partner would determine the interest charge by multiplying the deferred income by the interest factor and including the product in his income currently.[276]

Alternatively, if the Shortcut Lookback Method is applied by use of an assumed tax rate, the partnership could determine the amount of the interest charge applicable to deferred income by multiplying the interest factor by the product of the deferred income and the assumed tax rate. It would then allocate the interest charge among the partners in the same ratios in which the deferred income is allocated. The partners would pay the interest charge; they would deduct it from their current taxable income, unless an after-tax interest rate had been used to determine the interest charge.

### 5. Administrative Difficulties

a. *Section 453C(e)(4) of the Code.* The degree of complexity involved in determining an interest charge under the Shortcut Lookback Method depends upon the variation of the method that is used. For example, the variation employed in section 453C(e)(4) of the Code involves a long series of steps. (1) Deferred income reported in the current year is assigned to the year in which it was earned.[277] (2) The tax rate applicable to deferred income in the current year is determined. This determination requires recomputation of the current year's tax to exclude such income;[278] subtraction of the recomputed tax from the actual tax; and division of (a) the difference between those two amounts of tax by (b) the amount of deferred income. (3) The tax rate determined in step (2) is then multiplied by the amount of deferred income earned in each prior year to determine the tax deferred from each prior year. (However, if all

[275] *See* I.R.C. § 453C(e)(4)(B) (1986).

[276] Bradley-Gephardt bill, *supra* note 5, § 414(a).

[277] When an interest charge or credit is used to correct errors in the application of accrual rules, the taxpayer must assign any income that was earned in a year different from that in which it was reported to the year in which it was earned.

[278] The recomputation would not reflect changes in loss or credit carryovers to the current year that would result from application of accrual rules. *See supra* note 213 and accompanying text. Such changes would not have been determined since there is no recomputation of the tax of a prior year.

deferred income reported in the current year was earned in the same prior year, steps (2) and (3) can be condensed. The tax deferred from the prior year can be determined simply by subtracting the recomputed tax for the current year from the actual tax for the current year.[279] (4) The tax deferred from each prior year is multiplied by an interest factor appropriate for that year to determine the interest charge for tax deferred from that year. The amounts of the interest charge for tax deferred from each prior year are added together to determine the total interest charge. (5) The tax for the current year is recomputed (with inclusion of the deferred income) to permit deduction of the interest charge.[280] If an after-tax interest rate is used, step (5) is unnecessary.[281] (6) If the taxable income for the current year is

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[279] This would apparently be the procedure under I.R.C. § 453C(e)(4) (1986) if there is only one installment sale in progress during the year or if all installment sales for which payments are received in the current year were made in a single prior year. *See supra* note 231.

[280] *See* I.R.C. § 453C(e)(4)(B), (C) (1986) (deduction permitted for interest charge in year deferred income is received, but this deduction is not taken into account in determining portion of tax for the year attributable to receipt of installment payment for purposes of determining interest charge).

[281] The following is an example of how this variation of the Shortcut Lookback Method would be applied by a cash method professional to determine the interest charge with respect to fees collected in 1990. It is assumed that there is no explicit interest charged by the professional or his trade creditors, and that implicit interest is not identified. Identification of implicit interest would make step (1) more complicated since the implicit interest would have to be assigned to the years in which it was earned. This assignment of the interest could be facilitated by use of a Treasury table. *See supra* note 189. For an alternative way of dealing with implicit interest, see *infra* note 284.

*Assumptions*

(1) Fees collected in 1990: $1,000.
(2) Expenses paid in 1990: $400.
(3) Total taxable income in 1990 under cash method: $60,000.
(4) Tax rate for all relevant years: 25% for first $50,000 of income and 30% for additional income.
(5) Total tax liability for 1990 under cash method: $15,500.
(6) Interest rate throughout relevant years: 6% per annum, compounded semi-annually.

*Calculation*

*Step (1)*: Assign fees collected in 1990 and expenses paid in 1990 to years earned or incurred.
1988: $200 of fees earned.
1989: $300 of fees earned; $400 of expenses incurred.
1990: $500 of fees earned.
Determine net income (or loss) deferred from each prior year to the current year.
Net income deferred from 1988: $200.
Net loss deferred from 1989: $300 + ($400) = ($100).
Determine aggregate amount of net income (or loss) deferred from prior years: $200 + ($100) = $100.

redetermined after the return is filed, as a result of an audit or refund claim, or the carryback of a loss or credit,[282] one or more of these steps would have to be repeated.[283]

Although these steps are cumbersome, they are not conceptually difficult. The Internal Revenue Service could provide the taxpayer with worksheets or forms to facilitate making these calculations.[284]

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*Step (2)*: Determine tax rate applicable to deferred income in current year.
(a) Recompute tax liability for 1990 by excluding $100 of net income deferred to 1990 from prior years. The recomputed amount is $15,470.
(b) Subtract the recomputed tax liability ($15,470) from the actual tax liability for 1990 ($15,500). The difference is $30.
(c) Divide such difference ($30) by the amount of net income deferred to 1990 ($100). This yields the applicable tax rate of 30%.

*Step (3)*: Multiply applicable tax rate (30%) by net income (or loss) deferred from each prior year to determine the tax deferred (or accelerated) from each prior year.
(a) Tax deferred from 1988:
$200 x .3 = $60.
(b) Tax accelerated to 1989:
($100) x .3 = ($30).

*Step (4)*: Determine interest charge or credit.
(a) Interest charge with respect to tax deferred from 1988:
$60 x 0.26 (interest factor for 1988) = $15.60.
(b) Interest credit with respect to tax accelerated from 1989:
($30) x 0.12 (interest factor for 1989) = ($3.60)
(c) Net interest charge:
$15.60 + ($3.60) = $12.

*Step (5)*: Recompute tax liability for 1990 (with inclusion of $100 of deferred income) to reflect $12 deduction for interest charge. The recomputed tax is $15,496.40. Pay tax liability of $15,496.40 and interest charge of $12.

282 If the adjustment is due to a loss or credit carryback, it might be better not to redetermine the interest charge. *Cf.* Prop. Treas. Reg. § 1.995(f)-1(d)(3), 52 Fed. Reg. 3268 (1987) (discussed *supra* note 99).

283 Thus, the second step, determination of the tax rate applicable to the deferred income when recognized, would have to be repeated. If the tax rate arrived at differed from the tax rate arrived at in the original determination of the interest charge, the subsequent steps would also have to be repeated. In the case of an audit adjustment or refund claim, the difference between the interest charge as originally computed and the interest charge as recomputed would bear interest until the deficiency or refund was paid.

284 The procedure for determining a deferral surcharge under the yield-based approach is similar to the procedure for determining an interest charge under the Shortcut Lookback Method. In the case of a deferred payment obligation received for services performed, the procedure would be as follows. In step (1), the taxpayer would determine the issue price of the obligation by discounting at an assumed pre-tax interest rate. In step (2), the tax rate applicable to the deferred payment in the current year is determined, as under the Shortcut Lookback Method. In step (3), the issue price of the obligation is multiplied by the excess of 1 over the tax rate determined in step (2). In step (4), the amount determined in step (3) is multiplied by an after-tax interest factor. The after-tax interest factor is based upon the assumed interest rate used in step (1), the tax rate determined in step (2), and the period of deferral. In step (5), the amount determined

The number of calculations involved depends upon the number of years[285] from which income reported in the current year has been deferred.[286] For example, if the fees collected by a cash method professional in the current year were earned, in part, in each of the last ten years, the number of calculations involved would be quite large. If, however, all fees collected in the current year were earned in the current year or in the immediately preceding year,[287] then the number of calculations would not be excessive.[288] Similarly, if all collections of an installment seller in the current year were from sales made in only a few prior years (no matter how distant), the number of calculations would be manageable.

Even this variation of the Shortcut Lookback Method is much less burdensome to apply than the Lookback Recomputation Method because the Shortcut Lookback Method does not require recalculation of the tax for prior years covered by the transaction.[289] The Shortcut Lookback Method does require that

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in step (4) is subtracted from the amount of the deferred payment to arrive at the sum of the tax and the deferral surcharge. *See* Land, *supra* note 3, at 284–86; *see also supra* notes 3 & 189.

This method avoids the need to determine the portion of the implicit interest (with respect to a deferred payment) that is earned in each year of the deferral period. (Such determination could, however, be facilitated by use of a Treasury table. *See supra* note 189.) But this can also be achieved under a similar variation of the Shortcut Lookback Method. Under that variation, the issue price of the deferred payment obligation is determined by discounting at an assumed pre- tax interest rate. The interest charge is determined by multiplying the issue price by the product of the following amounts:

(1) One minus the tax rate applicable to the deferred payment when recognized; and

(2) The pre-tax interest factor appropriate to the period of deferral minus the after-tax interest factor appropriate to the period of deferral.

The product of items (1) and (2) could be provided in a Treasury table with entries reflecting various assumptions regarding the period of deferral, the tax rate used in item (1), and the tax rate used in item (2).

285 This assumes that income is not deferred between taxable years preceding the current year and that there is no acceleration of income.

286 Income reported in the current year would have to be assigned among each of these prior years; the income assigned to each of these prior years would have to be multiplied by the tax rate (determined in step 3) to determine the deferred tax for such year; and the deferred tax for each such year would have to be multiplied by the interest factor appropriate to that year.

287 *Cf. supra* text following note 214.

288 *See supra* note 281 (example of calculations where all fees collected in current year were earned either in that year or in one of the two immediately preceding years).

289 Under the Lookback Recomputation Method, tax must be recomputed for each prior year of the transaction from which income has been deferred. *See supra* notes 150–56 and accompanying text. The recomputation is used to determine the loan extended for each prior year so as to permit computation of the interest charge. Thus, this recomputation is in lieu of steps (2) and (3) described in text. If the Lookback Recomputation Method is used, as under I.R.C. § 460 (1986), to correct errors in applying accrual rules, it is necessary to recompute tax for each prior year from or to which income was deferred or accelerated.

a determination be made of amounts earned in each prior year that were recognized in the current year;[290] moreover, this variation of the Shortcut Lookback Method requires that the current year's tax be recomputed. But these steps are also required under the Lookback Recomputation Method. The Lookback Recomputation Method carries the additional requirement of recomputing taxes for, perhaps, several prior years. Such a requirement can result in many more tax calculations.[291] Under the Lookback Recomputation Method tax liability for a particular year may be recomputed more than once, and the taxpayer must then retain a record of the last previous recomputation. The need for retaining prior tax returns and the likelihood of applying a prior year's tax law are greater under the Lookback Recomputation Method than under the Shortcut Lookback Method.[292]

This variation of the Shortcut Lookback Method is not necessarily less burdensome to apply than the Current Comparison Method. The main difficulty in applying the Current Comparison Method is the recomputation of tax liability under accrual rules in each year that any deferred income is earned or recognized. Under this variation of the Shortcut Lookback Method it is necessary to recompute tax liability in each year that any deferred income is recognized. In the case of a dealer who makes installment sales or an investor with a large portfolio of securities, for example, such a recomputation may be required in every year. On the other hand, many less recomputations will be required under the Shortcut Lookback Method than under the Current Comparison Method if an investor holds a single security over a long holding period. Yet, the retrospective character of the Shortcut Lookback Method may make it more burdensome than the Current Comparison Method in cases where deferred income recognized in the current year was earned in several prior years.

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[290] In some cases, it may be necessary to determine the amounts deferred or accelerated among the years preceding the current year.

[291] Moreover, under the Lookback Recomputation Method, adjustments to loss or credit carryovers resulting from recomputation of the tax for an earlier year must be taken into account in recomputing tax for a later year. *See supra* text following note 213.

[292] Prior tax returns might be helpful even under the Shortcut Lookback Method to determine variations in the income earned and recognized in prior years. Prior law may have to be applied for that purpose.

b. *Other variations of Shortcut Lookback Method.* The application of the Shortcut Lookback Method is easier under its other variations. If an assumed tax rate is used to determine the amount of the deferred tax, no recomputation of any year's tax liability is required.[293]

It is still necessary to assign deferred income to the prior year in which it was earned. Once that is done, however, computation of the interest charge is quite simple. A Treasury table could contain the appropriate pre-tax or after-tax interest factor for each prior year, multiplied by the assumed tax rate.[294] The taxpayer would multiply the deferred income assigned to each prior year by the factor appropriate to that year. The interest charge would be the sum of the resulting products for each prior year. If the interest rate used in the table were an after-tax rate, there would be no need to deduct the interest charge; if not, the interest charge would be deducted from current taxable income, without the need for any recomputation of tax. There would also be no need to redetermine the interest charge as a result of audit adjustments unless the adjustments affected the amount of the deferred income recognized in the year.

The "simplified" method employed in the Bradley-Gephardt bill affords similar ease in application.[295] Under this method, the deferred income assigned to each prior year is multiplied by an after-tax interest factor appropriate to that year (found in a Treasury table); the sum of the resulting amounts for each prior year is then included in taxable income for the current year. The tax liability computed with respect to such taxable income includes the interest charge. If taxable income is adjusted as a result of an audit, the revised tax liability would also include a revised interest charge.

The Shortcut Lookback Method is much simpler to apply if an assumed tax rate or the "simplified" method is used. Yet the Shortcut Lookback Method may be burdensome to apply in cases where income reported in the current year was earned in

[293] Recomputation of tax liability is required neither to compute the deferred tax (step 2 described in *supra* note 281 and text accompanying note 278) nor to deduct the interest charge (step 5 described in *supra* note 281 and accompanying text). The interest charge can be determined before the tax for the current year is determined. Thus, the interest charge can be reflected in the first and only computation of tax for the current year. Steps (2) and (5) are thus eliminated.

[294] In this way, the taxpayer would need to perform only one multiplication rather than two.

[295] *See* Bradley-Gephardt bill, *supra* note 5, § 414.

a large number of prior years. This would be true, for example, in the case of a sale of a capital asset held for twenty years. Deferred gain or loss must be assigned to each prior year in which it accrued, based upon records retained from such years. Separate calculations must be made of the interest charge (or credit) with respect to each such prior year. By contrast, under the Current Comparison Method, changes in the value of the asset would be taken into account each year as they occur; no records would need be kept of gain or loss accrued in prior years. Only a single calculation of the interest charge (based upon the cumulative loan balance) would be required in each year.

However, if it is assumed that the gain or loss from a capital asset accrued at a uniform rate over the holding period, these complications under the Shortcut Lookback Method are reduced greatly. If the Shortcut Lookback Method were applied with an assumed tax rate, the Internal Revenue Service could provide a table showing the interest charge[296] for each dollar of gain accrued over a holding period of a specified number of years.[297] If the "simplified" method is used, the Internal Revenue Service could provide a table showing the percentage of the gain accrued over a specified holding period that is to be added to income in the year of sale.[298]

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[296] Similar considerations would apply to an interest charge with respect to compensation deferred until retirement. The value of the right to receive the compensation would increase from year to year as a result of accrual of interest, and possibly also as a result of increases in the likelihood of receiving contingent payments. *See supra* notes 193–95 and accompanying text. It would be very cumbersome for the taxpayer to determine the deferred tax (and the interest charge thereon) for each year beginning with the year in which the compensation was earned and ending with the year of receipt. However, in the case of noncontingent compensation (or compensation contingent in a way susceptible to actuarial measurement), the Treasury would be able to produce a table showing the interest charge per dollar of compensation received in the current year and earned by performance in a specified prior year, based upon uniform assumptions as to both the rate at which interest accrued on the compensation and the taxpayer's tax rate in each year. *See supra* note 284.

[297] *See* Wetzler, *supra* note 2, at 153 (example of such a table). Wetzler nevertheless considers the complexity of such and interest charge, including the need to determine the exact holding period, to be "an important objection." *Id.* at 125–26.

[298] *See* Brinner & Munnell, *supra* note 2, at 15 (table 7) (discussed in *supra* note 234); Cong. Budget Office, *supra* note 2 at 79–80 (similar table and revised schedule D). *See also* Gann, *supra* note 2, at 109, 145 & n.254 (such and interest charge "administratively feasible"). *But cf.* D. BRADFORD, *supra* note 2 at 49 (interest charge on capital gains determined under simplified method "would certainly be a complicating element and seems destined to remain in the academic category"); Hickman, *supra* note 2, at 245–46 (rejecting interest charge, such as that proposed by Wetzler, *supra* note 2, on grounds of complexity). He points to the "additional artihmentical steps" for the taxpayer, the difficulty of identifying gain with the asset's holding period, the complexity and inna-

### 6. Transactions Not Completed at Death

Determination of an interest charge by an estate or successor that reports income deferred by the decedent is much simpler under the Shortcut Lookback Method than under the Lookback Recomputation Method. Since the Shortcut Lookback Method does not require recomputation of tax liability for a prior year, there would be no need for the successor to recompute the tax liability of the decedent.

The tax rate used to determine the tax deferral loan could be either the successor's tax rate applicable to the deferred income in the year recognized[299] (or, under the "simplified" method, the successor's tax rate applicable to the additional "interest amount")[300] or an assumed tax rate. Use of an assumed tax rate may be preferable, since it would simplify calculation of the interest charge. Moreover, there may be no reason to expect that the assumed rate would be a poorer approximation than the successor's tax rate would be of the decedent's tax rate that would have applied when the income was earned.[301]

While the successor will not need to recompute tax liability of the decedent for prior years, the successor may require access to the decedent's tax records. It will be necessary for the successor to determine the amount of income deferred by the decedent and the year[302] from which it was deferred.[303]

## D. *Simultaneous Use of More than One Method*

If a taxpayer engages in more than one type of transaction involving deferral, he might be subject to two or more interest

curacy of "simplifying assumptions" needed to determine the interest charge, and the "complicated tax planning" that taxpayers would engage in "to take maximum advantage of the simplified instructions," such as ratable accrual of gain over the holding period. *Id. See also* note, *supra* at 794 & n. 105 ("transactional complexity" and "only small gains in more accurate income measurement").

[299] *See* I.R.C. § 1 (1986).

[300] *See* Bradley-Gephardt bill, *supra* note 5, § 414.

[301] If, however, the deferred income was a very large amount, e.g., $200,000, most of it would not be taxed at the 15% rate regardless of when and by whom it was reported. *See* I.R.C. § 1 (1986). Thus, the use of the successor's rate applicable to the income when reported might be a closer approximation than an assumed rate. *See supra* note 128.

[302] In the case of a capital asset, the successor would need to determine the asset's holding period.

[303] If income were deferred between years preceding the current year, or income were accelerated between such years or to the current year, further information would be required.

provisions. This would not involve additional complications if each interest provision employs the same method for determining the interest charge.[304]

If the interest provisions employ different methods for determining the interest charge, a rule would be needed to prescribe the order in which the different methods would be applied. No such ordering rule has yet been provided by Congress although it has recently enacted a number of interest provisions utilizing different methods.[305] Under this ordering rule, the Current Comparison Method or Tracing Method would be applied first,[306] the Lookback Recomputation Method second, and the Shortcut Lookback Method last. If the Shortcut Lookback Method were applied with an assumed tax rate, however, no coordination with other methods would be necessary.

The amounts of the accrual basis taxable income and tax liability determined for each year under the Current Comparison Method or under the Tracing Method would be the basis used for applying the Lookback Recomputation Method or for applying the Shortcut Lookback Method, if the Lookback Recomputation Method were not applied.[307] The amounts of the hypothetical taxable income and tax liability determined under the Lookback Recomputation Method would be the basis used for applying the Shortcut Lookback Method (assuming that it is not applied with an assumed tax rate). Alternatively, for the sake of simplicity, the Shortcut Lookback Method could be applied without regard to the application of the other two methods (i.e., based upon the actual taxable income and tax liability). If both the Current Comparison Method and the Tracing Method were

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[304] In that case, a single combined computation of the interest charges can be made.

[305] I.R.C. § 460 (1986) (applicable to long-term contracts) uses a form of the Lookback Recomputation Method. *See supra* notes 5 & 178–82 and accompanying text. I.R.C. § 453C(e)(4) (1986) (applicable to certain installment sales) uses a form of the Shortcut Lookback Method. *See supra* notes 4 & 231 and accompanying text. I.R.C. §§ 1291, 1294 (1986) (applicable to United States investors in a PFIC) use forms of the Shortcut Lookback Method and the Tracing Method, respectively. *See supra* notes 6, 132 & 232 and accompanying text. I.R.C. § 995(f) (1986) (applicable to shareholders in a DISC) employs a method of determining the interest charge on a current basis. *See supra* notes 7 & 84–85 and accompanying text.

[306] The Current Comparison Method or the Tracing Method requires recomputation of tax for a year on a current basis, and the Lookback Recomputation Method requires recomputation of tax generally on a retrospective basis. Thus, the recomputation of tax for any particular year under the Current Comparison Method or the Tracing Method necessarily occurs before the recomputation of tax for that year under the Lookback Recomputation Method. An ordering rule is required, however, because, under the Lookback Recomputation Method, the current year's tax may also be recomputed.

[307] *Cf. supra* note 216 and accompanying text.

being employed, income from transactions subject to an interest charge under one method would be reported under the accrual method for purposes of applying the other method.

### E. *Transition*

It might be argued that, in order to prevent further uncompensated advantage from deferral after the effective date of an interest charge, tax deferral loans outstanding as of the effective date should bear interest from that date forward. Determination of the amount of such tax deferral loans, however, would be much too burdensome under any of the alternative methods. It would require, at the very least, determination of the amount of income earned in any pre-effective date year that was not recognized as of the effective date; except under the Shortcut Lookback Method, it would also require recomputation of tax for each such prior year.

Instead, an interest charge should be imposed only with respect to income earned (or transactions begun) after the effective date.[308] In this case, transition should not result in any special liquidity or bunching problems. Assuming that income has been deferred but not accelerated prior to the effective date, the interest charge for any year after the effective date would generally[309] be no more than it would have been if an interest charge had been imposed initially.

## V. Assessment of Charging Interest on Tax Deferral Loans

Failure to tax income as it accrues results in inequity, distortion of behavior, and budgetary problems. Nonetheless, Congress has determined that, in many situations, accrual taxation

[308] To avoid excessive complications, the interest charge should not be applied to a long-term contract in progress at the effective date. It might be appropriate, however, to impose an interest charge with respect to gain accrued after the effective date on marketable securities held as of the effective date. *Compare* TRA 1986, *supra* note 4, § 804(d)(1) (§ 460 will apply to any contract entered into after February 28, 1986) *with id.* § 1235(h) (interest charge provisions with respect to earnings of PFIC are applicable to taxable years of foreign corporations beginning after December 31, 1986).

[309] If an interest charge had been imposed initially under the Current Comparison Method, however, there might have been an accumulated negative loan balance with respect to income earned before the effective date, as a result of an increase in applicable tax rates from the time that the income was earned to the time that it was recognized.

is precluded by problems of valuation and liquidity. In these situations, it is worth considering the alternative of imposing an interest charge to compensate for tax deferral or the alternative of applying accrual rules with an interest provision that corrects errors.

If an interest charge accurately compensates for tax deferral, it will eliminate inequity and distortion of behavior resulting from deferral. In addition, an interest charge ameliorates government budgetary problems resulting from deferral although it does not eliminate them. An interest charge can accomplish these ends without creating liquidity problems for taxpayers. Moreover, in situations where accrual taxation is precluded solely by valuation difficulties, these difficulties can be overcome by an interest provision that corrects errors in applying accrual rules; in this way, the disadvantages of deferral are eliminated.

An interest charge cannot be entirely accurate in compensating for the value of deferral. The value of deferral depends upon the marginal rate of return on investments, which varies among taxpayers. Yet, to make an interest charge administrable, a uniform interest rate must be used by all taxpayers. This inaccuracy is not, however, a reason for rejecting use of an interest charge. If the interest rate is set on the low side, e.g., at the applicable federal rate,[310] most taxpayers will pay fairly complete compensation for the value of deferral, while few or no taxpayers will pay excessive compensation. The interest charge will be more accurate for nearly all taxpayers than the present law, which does not exact any compensation for the value of deferral. The interest charge will also ameliorate the government's budgetary problems.

An interest charge is feasible only if the amount of the tax deferral loan and the interest thereon can be determined without excessive difficulty and with a sufficient degree of accuracy. These aspects of an interest charge must be assessed in the context of specific deferral provisions.

### A. *Installment Sales by Dealers*

The Tax Reform Act of 1986 imposed an interest charge, determined under the Shortcut Lookback Method, upon use of

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[310] *See supra* notes 43–44 and accompanying text.

the installment method by dealers in real property, but only in very limited circumstances.[311] It would be feasible to extend this interest charge to all installment sales by dealers in real or personal property.[312] With such an interest charge, there would be compensation for the benefits of deferral under the installment method in all cases. In contrast, the proportionate disallowance rule of the Tax Reform Act of 1986 eliminates deferral only to the extent that indebtedness of the taxpayer is allocable, by proration, to his installment obligations.[313]

Alternatively, the Current Comparison Method could be used to determine the interest charge since the sales income could generally be determined without great difficulty[314] as it accrues.[315] Use of this method would result in greater accuracy in determining the interest charge, particularly if steeper rate schedules are introduced by future legislation. This method would also be more accurate in permitting deduction of the interest charge as it accrues.

Use of the Current Comparison Method would permit imposition of a requirement that the interest charge be paid as it accrues. This requirement would improve government revenues and might not be too burdensome for taxpayers. If current payment of the interest charge were considered a hardship, taxpayers could be permitted to restrict current interest payments to a percentage of their after-tax income.

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[311] *See* I.R.C. § 453C(e)(4) (1986). For legislative developments occuring as this Article went to press, see Author's Note and Addendum.

[312] The income earned in prior years might be determined by hindsight, by reference to the amount collected in the current year. This method would be an accurate way of dealing with bad debts unless a risk premium was incorporated in an explicit interest charge. *See supra* notes 184 & 188 and accompanying text.

[313] *See supra* note 13; Note, *supra* note 8, at 410–11 (proportionate disallowance rule merely corrects a "particularly egregious abuse of the installment method"; alternatives of interest charge or limiting buyer's basis are favored). *See also* Sheppard, *supra* note 8, at 457 (Ginsburg argues that the Treasury proposal to treat pledge of installment obligation as payment is a "second-best solution," compared with charging interest on deferred tax).

[314] Under the TRA 1986, a reserve for bad debts is no longer permitted. *See supra* note 185. Accrual taxation of sales income without allowance of a bad debt reserve may not be accurate, however, if the taxpayer does not incorporate a risk premium in an explicit interest charge. *See supra* note 184. This concern can be addressed under the Current Comparison Method by permitting use of a bad debt reserve for purposes of determining hypothetical accrual tax liability, at least where there is no explicit interest charge or late payment fee. *Cf.* I.R.C. § 448(d)(5) (1986) (discussed *supra* note 184). However, this would complicate the application of the Current Comparison Method.

[315] For a comparison of the administrative burden of the Shortcut Lookback Method and the Current Comparison Method, see *supra* text following note 292; see also *supra* note 314 (need for bad debt reserve under Current Comparison Method).

Determination of the interest charge, under either method, may not be significantly more complex than applying the proportionate disallowance rule and making the adjustment for use of the installment method for purposes of determining alternative minimum taxable income.[316] With the imposition of an interest charge, both of these provisions of present law could be repealed.[317] Affected taxpayers, moreover, would retain the option of paying tax on income from installment sales as it accrues to avoid the complication of determining the interest charge. Determination of the interest charge with respect to deferred income of a partnership or an S corporation would not pose great difficulties under the Shortcut Lookback Method, or even under the Current Comparison Method if the entity adopted accrual accounting of installment sales for internal accounting purposes.

### B. *Long-Term Contracts*

Under section 460 of the Code, added by the Tax Reform Act of 1986, contractors must report 40% of contract items (or, at their option, 100%) under the percentage of completion method.[318] Errors in estimating percentage of completion are corrected with an interest charge (or credit) determined by hindsight under the Lookback Recomputation Method. This provision should be extended to 100% of items under a long-term contract.[319]

Elimination of deferral by mandated use of the percentage of completion method improves equity and economic efficiency

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[316] If a current allowance for bad debts would be more accurate in determining accrual tax liability under the Current Comparison Method, it would also be more accurate under the proportionate disallowance rule and for the purpose of determining alternative minimum taxable income.

[317] It would also be possible to continue to apply the proportionate disallowance rule and to impose the interest charge with respect to gains not subject to that rule. However, this would involve excessive complications for the taxpayer and for the Internal Revenue Service. Moreover, it is not clear that the proportionate disallowance rule adequately distinguishes situations where liquidity is a concern from those where it is not. Under the proportionate disallowance rule, use of the installment method may be denied even though loan proceeds were received and spent for other purposes before the installment sale was made or contemplated. *See generally* Note, *supra* note 8, at 411 ("[m]any taxpayers who did not consciously borrow against their installment notes will become liable for extra taxes" under the proportionate disallowance rule).

[318] *See* I.R.C. § 460(a), (b)(1) (1986).

[319] For legislative developments as this Article went to press, see Author's Note and Addendum.

and also reduces government budgetary problems. The interest charge (or credit) facilitates use of the percentage of completion method. The percentage of completion method becomes more palatable to taxpayers because they are protected against the consequences of overestimation of income in the early years of the contract. (This result assumes, however, that section 460 of the Code is amended to require precise repayment of any tax deferral or tax acceleration loan upon the completion of the contract.) While the hindsight determination of income used to determine the interest charge (or credit) may not be entirely accurate, any inaccuracy is likely to be in the taxpayer's favor.

The taxpayer's initial determination of the percentage of completion, based upon estimates, is not likely to be disputed by the Internal Revenue Service and is not likely to be grossly distorted by the taxpayer since errors favoring the taxpayer are also compensated with interest. (This again errors favoring the taxpayer are also compensated with interest. (This again assumes precise repayment of any tax deferral or tax acceleration loan.) If the taxpayer were given the option of using the Shortcut Lookback Method to determine the interest charge or credit (as under the Bradley-Gephardt bill), opportunities for manipulation and dispute would be greater, although perhaps not intolerable under the 1986 rate schedules.

Application of section 460 of the Code is extremely complex due to the need to recompute tax liabilities of prior years (especially if procedures are followed that insure complete accuracy in making the recomputation). Yet Congress apparently concluded that the application of section 460 of the Code would not be too burdensome for most[320] contractors.[321] Extension of the provision to 100% of the contract items would not increase complexity, but it would result in complete elimination of income deferral with respect to long-term contracts.

Extending mandatory use of the percentage of completion method to 100% of the contract items might result in liquidity

[320] These rules do not apply to a contract for construction or rehabilitation of real property that is estimated to be completed within two years if the average annual gross receipts of the contractor determined from three prior taxable years do not exceed $10 million. I.R.C. § 460(e) (1986). Instead of entirely excluding small real estate contractors from these rules, these contractors might be required to pay an interest charge, determined under the Shortcut Lookback Method, compensating for their use of the completed contract method. *See* Bradley-Gephardt bill, discussed *supra* notes 5, 150 & 181 and accompanying text.

[321] For a legislative proposal to provide a "de minimus" exception to the lookback interest provision under section 460 of the Code, see Addendum.

problems for some contractors, however.[322] To avoid these problems, taxpayers might be permitted to defer tax liability with respect to 60% of the contract items by use of the completed contract method (as under present law). But this deferral would be conditioned on their precise repayment of the tax deferral loan, with interest determined under section 460 of the Code, upon completion of the contract.[323]

### C. *Income from Professional Services*

Under the Tax Reform Act of 1986, accrual taxation of professional fees was rejected. Unless this decision is reversed, the deferral of such income should be subject to an interest charge determined under the Shortcut Lookback Method.

Imposing such an interest charge would be much less burdensome than imposing an accrual requirement. Since the tax and the interest charge would be payable only upon collection of the fees, there would be no liquidity problems; nor would there be any bunching of tax payments (or the interest charge) into a transition period.

Fees (and implicit interest)[324] earned in each year would be determined by hindsight. Thus, little difficulty or controversy

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[322] *See generally supra* note 30.

[323] This also would not involve additional complexity. In determining his tax liability, the taxpayer would take into account 40% of the items under the contract under the percentage of completion method and the remainder under the completed contract method, as under current section 460. Upon completion of the contract, he would recompute tax liability for each year under the percentage of completion method, with the benefit of hindsight. This recomputation would extend to 100% of the items under the contract (rather than 40%, as under current section 460). He would then pay an interest charge, or receive an interest credit, with respect to the difference between the tax paid in each year and the tax as so recomputed. He would also pay or receive the amount of any difference between the aggregate of the tax payments for all years of the contract (including the current year) and the aggregate of the recomputed tax amounts for all such years. *See* Bradley- Gephardt bill, described *supra* notes 5, 150 & 181 and accompanying text.

[324] Implicit interest could be assigned to the year earned since the period of the loan would be known by hindsight. This could be facilitated by a Treasury table. *See supra* note 189 and accompanying text. (By contrast, under an accrual method, determination of implicit interest would be impractical due to the difficulty of determining the period of the loan to the client. *See supra* note 187 and accompanying text.) Moreover, the interest charge with respect to implicit interest can be determined by an alternative, shortened approach. *See supra* note 284. Accounting for implicit interest would, however, increase the complexity of determining the interest charge and might be rejected for this reason. Nevertheless, taxpayers should at least be given the option of assigning implicit interest to the year earned because this option would be important to prevent overstatement of the interest charge when collection of the fee is long delayed.

should be involved in that determination.[325] The determination of the professional's income under the Shortcut Lookback Method would likely be more accurate than the determination of his income under the cash method, and might perhaps be more accurate than the determination that, in practice, would be made under an accrual method.[326]

Generally fees collected during the current year would have been earned in that year and in only a fairly small number of prior years, so that the number of calculations involved would not be excessive. Unlike the accrual method, the Shortcut Lookback Method would not be difficult to apply when a professional practice is conducted by a partnership using the cash method for internal accounting. Since small businesses would be able to compute and pay the interest charge without enormous difficulty, no special exclusion of such businesses would be required.[327]

The major drawback of such an interest charge would be the potential for inaccuracy in determining the amount of the tax deferral loan and the failure to require precise repayment of that loan. While the Lookback Recomputation Method avoids these problems, its greater complexity would make a requirement of its use unjustified.

Under the present rate schedule, the Shortcut Lookback Method, using either the approach employed under section 453C of the Code or the simplified method, would be reasonably accurate. The tax rate applicable to fees in the year of collection (or to the additional interest amount under the simplified method) usually would not vary too greatly from the tax rate that would have applied to the fees if reported in the year earned.[328] Taxpayers might be permitted to choose between

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[325] If a fee is earned by performance of services spanning more than one year, it would be necessary to allocate the fee between those years. If time records were kept, the allocation could be based upon hours worked in each year. Otherwise, the allocation might be made on the assumption that services were performed at a uniform rate over the contract period. This allocation of fees after completion of services under the Shortcut Lookback Method would be much simpler than a determination of the fees earned by partial performance as of the end of the current year under the accrual method. *See* Blum, *"Accrual" Fate*, *supra* note 26, at 630–34 & n.144.

[326] *See supra* notes 185–92 and accompanying text.

[327] *See supra* note 26.

[328] Alternatively, if inaccuracy to the disadvantage of taxpayers under the Shortcut Lookback Method were a great enough concern, a uniform tax rate of 15% for individuals and corporations could be used to determine the tax deferral loan. While the use of this rate would make the interest charge much too low in many cases, it would generally avoid overcharging.

these two variations of the Shortcut Lookback Method. Although easier to apply, the simplified method may result in a somewhat higher interest charge.[329] Taxpayers should also be given the option of applying the more accurate Lookback Recomputation Method, if this is done consistently.

Whichever method is chosen, the interest charge would be determined with an after-tax interest factor (to be provided in a Treasury table); the tax rate used would be the highest applicable tax rate for each year over which the interest charge accrued. Use of this after-tax interest factor would be relatively simple and would spare the taxpayer from the disadvantage of a delayed deduction of the interest charge.

## D. *Capital Gains*

### 1. Marketable Securities

If Congress fails to require accrual taxation of marketable securities, an interest charge (or credit) should be provided. Since changes in the value of such securities can be readily determined as they occur, the interest charge could be determined under the Current Comparison Method. The Current Comparison Method would accurately determine the amount of the interest charge and permit its current deduction (which would contribute to accuracy). Under the Current Comparison Method, there could be a requirement that taxpayers make annual payments of accrued interest, absent a showing of hardship in liquidating securities for this purpose. Alternatively, annual payments of accrued interest could be limited to a percentage of after-tax income.

The determination of the interest charge would be greatly simplified by the use of the Shortcut Lookback Method with an assumed distribution of gain in the holding period and an assumed tax rate.[330] Using this method, however, would greatly reduce accuracy.

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[329] *See supra* notes 243–46 and accompanying text.
[330] *See supra* notes 296–97 and accompanying text.

### 2. Other Capital Assets

The desirability of an interest charge is less evident for other capital assets. Even with the benefit of hindsight, it would not be feasible to determine either the rate at which gain or loss accrued during an asset's holding period or, thus, the amount of the tax deferral (or acceleration) loan, if any, which is outstanding during each year of the holding period. A uniform assumption as to the rate at which the gain or loss accrued would have to be employed. This assumption could result in the imposition of a very large interest charge on a taxpayer who, in fact, received no tax deferral loan because his gain accrued entirely in the year of sale. Thus, imposing an interest charge would be much less accurate than present law in some cases (even though it would probably be more accurate, on average, than present law).

In light of these problems of accuracy, it may not be acceptable to introduce the complexity of an interest provision with respect to capital assets other than marketable securities.

### 3. Installment Sales

An interest charge should, nevertheless, be imposed to compensate for delay in reporting gains from these assets after their sale as a result of use of the installment method.[331] The interest charge might be determined under the Shortcut Lookback Method, as provided in section 453C(e)(4) of the Code. An after-tax interest factor could be used reflecting the highest applicable tax rate in each year that the interest charge accrued.[332] This method would permit a hindsight determination of the amount of the installments,[333] when the sales price was contingent.[334]

If the sales price is not contingent, the interest charge could be determined under the Current Comparison Method or the

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[331] For legislative developments as this Article went to press, see Author's Note and Addendum.

[332] This would avoid the disadvantage to taxpayers of the delayed deduction of the interest charge under section 453C(e)(4) of the Code and would be relatively simple to apply. However, it would be too favorable to a taxpayer whose tax rate was less than the maximum rate in any year in which the interest charge accrued.

[333] *See supra* note 189.

[334] Tax payments would be determined under the installment method (unless a taxpayer elected not to apply it). *See* I.R.C. § 453(j)(2) (1986); Temp. Treas. Reg. § 15A.453-1(c) (as amended in 1981) (allocation of basis in a contingent payment sale). *See* discussion in Land, *supra* note 3, at 264–66, 273–75.

Tracing Method. This variation would permit imposition of a requirement that interest be paid currently (if this were not considered too harsh)[335] and would also permit current deduction of the interest charge.[336] In the case of an isolated sale, determination of the interest charge may not be much more complex under the Tracing Method than under the Shortcut Lookback Method.[337] If, however, the taxpayer employs the Current Comparison Method to determine the interest charge with respect to marketable securities or dealer installment sales, it might be easier to apply the Current Comparison Method to the isolated installment sale as well.[338] The taxpayer could avoid the complications of determining the interest charge by electing out of the installment method.

It would not be possible to determine the amount of the interest charge (or require repayment of the tax deferral loan) with complete accuracy, whichever method is used. The appropriate tax rate for determining the amount of the tax deferral loan (based upon the model of accrual taxation) is the rate applicable to the gain as it accrued (which, as discussed previously, cannot be determined). This rate may differ from the rate applicable to the gain in the year of sale (used under the Current Comparison Method, the Tracing Method, and the Lookback Recomputation Method) or the rates applicable to the gain in the year installments are received (used under section 453C of the Code). The taxpayer would likely not be disadvantaged, however, by use of one of these methods since he could time

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[335] *See supra* note 117 and accompanying text.

[336] *See supra* note 332 and accompanying text.

[337] Under the Tracing Method, tax liability would need to be recomputed *only in the year of sale*. If interest is to be paid (or at least deducted) on an annual basis, the accrued interest would be determined in each year by multiplying the remaining deferred tax liability by the appropriate interest rate for that year. In each year that an installment is received, the portion of the remaining deferred tax liability to be paid in that year would be determined by reference to the percentage of the previously unrecognized gain that is recognized in that year (under the installment method). Complications might arise if the taxpayer is a partner in a partnership using the installment method for internal accounting purposes.

Under I.R.C. § 453C(e)(4) (1986), tax liability would have to be recomputed *in each year in which an installment is received* to determine the deferred tax liability attributable thereto. This deferred tax would be multiplied by the appropriate interest factor (based upon the period having elapsed since the year of sale) to determine the interest charge for the year.

[338] Tax liability might be recomputed in each year, in any event, to apply the Current Comparison Method to the marketable securities or dealer installment sales. The recomputation of tax could simultaneously reflect denial of the use of the installment method for the isolated sale. For comparison of the Tracing Method with the Current Comparison Method, see *supra* notes 139–47 and accompanying text.

the sale or the receipt of installments to avoid the application of an excessively high marginal rate in determining the amount of the tax deferral loan.[339]

The usefulness of an interest charge depends upon the context. But, at least in some cases where accrual taxation has been rejected, an interest charge can be designed so as to compensate for the benefits of tax deferral (or to correct errors in accrual taxation) with a fair degree of accuracy and without problems of liquidity or excessive administrative difficulties. In these cases, an interest charge compares favorably to present law disregarding the value of deferral.

## ADDENDUM

### I. LONG-TERM CONTRACTS

In the Omnibus Budget Reconciliation Act of 1987 (the "1987 Act"), signed by the President on December 22, 1987, Congress extended the requirement that long-term contracts be reported under the percentage of completion method, and that errors be corrected with a lookback interest charge or credit, to 70% of the items under the contract (as compared with 40% under prior law).[340] This was a compromise between the House of Representatives, which voted to require use of the percentage of completion method and the lookback interest provision with respect to 100% of contract items,[341] and the Senate, which voted to retain the existing rules.[342] The new rules apply to

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[339] Under present law, taxpayers have two alternate ways to determine the tax on installment gains. They may use the rates applicable in the year in which installments are received (under the installment method), or they may use the rate applicable in the year of sale (by electing out of the installment method). Under the Current Comparison Method or the Tracing Method, however, the taxpayer's options would be reduced because a tax at the rate applicable in the year of sale would ultimately be payable.

[340] *See* Omnibus Budget Reconciliation Act of 1987, Pub. Law No. 100-203, § 10203(a) [hereinafter 1987 Act].

[341] *See* Revenue Bill of 1987, H.R. 3545, 100th Cong., 1st Sess. (as passed by the House of Representatives on October 29, 1987), *reprinted in* 74 Stand. Fed. Tax Rep. (CCH) No. 44, Part II, at § 10115(a) (October 26, 1987) [hereinafter House Bill].

[342] The Senate Finance Committee on October 16, 1987, approved the provision later passed by the House. *See Revenue Provisions Approved by the Senate Finance Committee on October 16, 1987*, 74 Stand. Fed. Tax Rep. (CCH) No. 44, Part I, at § 6501(a) (October 26, 1987) [hereinafter *October 16 Senate Finance Committee Bill*]. But the Senate Finance Committee dropped this provision from its bill on December 3, 1987. *See* STAFF OF SENATE FINANCE COMMITTEE, 100TH CONG., 1ST SESS., OMNIBUS BUDGET RECONCILIATION ACT OF 1987, EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON DECEMBER 3, 1987 FOR INCLUSION IN LEADERSHIP DEFICIT REDUCTION AMENDMENT 100-63 (Comm. Print 1987).

contracts entered into after October 13, 1987. An exception was made for certain qualified ship-building contracts.[343]

The version of the legislation passed by the House of Representatives on October 29, 1987, and the version approved by the Senate Finance Committee on October 16 contained a "de minimus exception" to the lookback interest provision in the case of a contract completed within two years of the contract commencement date if the gross contract price does not exceed the lesser of $1 million or 1% of the taxpayer's average annual gross receipts for the three taxable years proceding the year in which the contract was completed.[344] The provision sought to address the concern that "the requirements imposed on taxpayers under the lookback method may, in some circumstances, be unduly burdensome."[345] The provision was not, however, included in the 1987 Act, although it may be included in technical correction legislation in 1988.

## II. Installment Method

### A. *Dealers*

The 1987 Act repeals the use of the installment method with respect to dispositions by dealers.[346] This eliminates the need to impose an interest charge to compensate for tax deferral with respect to such dispositions. The repeal is effective for dispositions after December 31, 1987.[347] A disposition by a dealer includes a disposition of personal property by a taxpayer who regularly sells personal property on the installment plan or a disposition of real property which is held by the taxpayer for sale to customers in the ordinary course of his business. An exception is made for dispositions of property used or produced in the trade or business of farming.[348]

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[343] *See* 1987 Act, *supra* note 340, § 10203(b).

[344] *See October 16 Senate Finance Committee Bill*, *supra* note 342, § 6847 (adding I.R.C. § 460(b)(4)); House Bill, *supra* note 341, § 10208(c)(2)(A) (adding I.R.C. § 460(b)(4)(B)).

[345] *See* H.R. Rep. No. 391, 100th Cong., 1st Sess. 1235 (October 26, 1987), *reprinted in* 74 Stand. Fed. Tax Rep. (CCH) No. 45 (November 2, 1987) [hereinafter House Report].

[346] *See* 1987 Act, *supra* note 340, § 10202(b)–(c) (amending I.R.C. § 453(b)(2)(A) and adding I.R.C. § 453(l), and amending I.R.C. § 453A, respectively).

[347] *Id.* § 10202(e)(2)(A).

[348] *Id.* § 10202(b)(2) (to be codified at I.R.C. § 453(l)(1), (2)(A)).

There is also an exception for certain dispositions of time shares and residential lots if the taxpayer elects to pay an interest charge compensating for tax deferral under the installment method.[349] Under prior law, these dispositions were excepted from the proportionate disallowance rule if the taxpayer elected to pay the interest charge provided under section 453(e)(4) of the Code.[350]This interest charge provision has now been shifted to section 453(1)(3) of the Code, but is essentially unchanged.

Thus, the interest charge is determined and payable only when an installment is received. The amount of the tax deferral loan is considered to equal the amount of tax payable in any year that is attributable to the receipt of payments on installment obligations during that year. Interest is determined at the applicable federal rate in effect at the time of the sale (compounded semiannually) for the period beginning on the date of sale and ending on the date that the payment is received.[351] This method of computing the interest charge is a variation of the Shortcut Lookback Method.

## B. *Nondealers*

The 1987 Act preserves the use of the installment method by nondealers. Congress repealed the proportionate disallowance rule, which limited the application of the installment method in some cases,[352] and Congress eliminated restrictions on use of the installment method by nondealers under the alternative minimum tax.[353] At the same time, Congress imposed an interest charge to compensate for tax deferral with respect to an installment obligation arising from the disposition of real property used in the taxpayer's trade or business or held for the production of rental income if the sales price of the property exceeds $150,000 (a "nondealer installment obligation").[354] The interest charge applies to a nondealer installment obligation arising in a particular taxable year only if the aggregate face amount of all

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[349] *See id.* § 10202(b)(2) (to be codified at I.R.C. § 453(1)(2)(B), (1)(3)).
[350] *See supra* notes 4, 46, 52, 72, 231 & 268 and accompanying text.
[351] *See* 1987 Act, *supra* note 340, § 10202(b)(2) (to be codified at I.R.C. § 453(1)(3)).
[352] *See id.* § 10202(a) (repealing I.R.C. § 453C). The repeal is effective for dispositions in taxable years beginning after December 31, 1987. *Id.* § 10202(e)(1). For a description of the proportionate disallowance rule, see *supra* notes 13, 15 & 28 and accompanying text.
[353] *See* 1987 Act, *supra* note 340, § 10202(d) (amending I.R.C. § 56(a)(6)).
[354] *Id.* § 10202(c) (to be codified at I.R.C. § 453A(a)(1), (b)).

nondealer installment obligations of the taxpayer which arose during that year and which are outstanding as of the close of that year exceeds $5 million.[355] There are exceptions for dispositions of personal use property, farm property, and time shares and residential lots as to which the taxpayer elects to pay the interest charge provided under section 453(l)(3) of the Code.[356] Congress also provided that, in the case of a nondealer installment obligation, the net proceeds of any indebtedness that is secured by the obligation are generally treated as payment received on the obligation.[357]

In the bill approved by the Senate Finance Committee on October 16, 1987, the interest charge with respect to nondealer obligations[358] was determined by the same method and with the same interest rate as are employed under section 453(l)(3) of the Code to determine the interest charge with respect to certain dispositions of time shares and residential lots.[359] However, in the 1987 Act, a different method of determining the interest charge and a different interest rate are employed with respect to nondealer installment obligations.

Under the 1987 Act, the interest charge with respect to nondealer installment obligations is determined and is payable on a current basis (as under the Current Comparison or Tracing Method), without waiting for any installments to be received. The amount of the tax deferral loan is determined by reference

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[355] *Id.* § 10202(c) (to be codified at I.R.C. § 453A(b)(2)). If the $5 million threshold is exceeded in the year an obligation arises, interest continues to be payable with respect to such obligation in any subsequent year if the obligation is still outstanding at that year's close. *Conference Report on the Omnibus Budget Reconciliation Act of 1987*, 100th Cong., 1st Sess., 205 CONG. REC. H12216 (daily ed. Dec. 21, 1987) [hereinafter *Conference Report*].

[356] 1987 Act, *supra* note 340, § 10202(c) (to be codified at I.R.C. § 453A(b)(3), (4)). *See supra* notes 349–51 and accompanying text.

[357] 1987 Act, *supra* note 340, § 10202(c) (to be codified at I.R.C. § 453A(d)).

[358] Under that bill, the interest charge would have applied to any installment obligation arising from a disposition of property by a nondealer, subject to the $5 million threshold. *See October 16 Senate Finance Committee Bill*, *supra* note 342, § 6503(c) (adding I.R.C. § 453(m)(3)).

[359] However, under the aforementioned Senate Finance Committee's October 16 bill, the amount of the tax deferral loan with respect to nondealer installment obligations is adjusted to reflect the $5 million threshold. *See id.* § 6503(c) (adding I.R.C. § 453(m)); *Senate Finance Committee Report on Revenue Bill of 1987, as Reported to the Senate Budget Committee on October 16, 1987*, *reprinted in* 74 Stand. Fed. Tax Rep. (CCH) No. 46, at 163 (November 5, 1987). *See also supra* notes 349–51 and accompanying text. The interest charge provision for nondealer installment obligations was dropped from the aforementioned Senate Finance Committee's October 16 bill on December 3, 1987, and did not appear in the bills approved by the full House and Senate.

to an assumed tax rate (as under one variation of the Shortcut Lookback Method).

The tax deferral loan outstanding during the taxable year with respect to any nondealer installment obligation is determined by multiplying (1) the amount of gain that remains unrecognized as of the close of that year with respect to such obligation (regardless of when the obligation arose), by (2) the maximum rate of tax in effect for individuals or corporations, as the case may be, for that taxable year. Only the applicable percentage of this amount is taken into account. The appliable percentage with respect to installment obligations arising in any taxable year is determined by dividing (1) the portion of the aggregate face amount of such obligations outstanding as of the close of that year in excess of $5 million, by (2) the aggregate face amount of such obligations outstanding as of the close of that year. The interest charge for the taxable year with respect to any installment obligation is determined by multiplying the applicable percentage of the tax deferral loan with respect to such obligation by the underpayment rate in effect for the month with our within which the taxable year ends.[360] The underpayment rate is the shrot-term federal rate plus three percentage points.[361] The Treasury is authorized to prescribe regulations providing for the application of the interest charge in the case of contingent payments, short taxable years, and pass-thru entities.[362]

In designing this interest charge, Congress evidently determined that requiring payment of the interest charge on a current basis would not create undue liquidity problems for taxpayers. Current payment of the interest charge has the advantages of reducing the Treasury's loans to taxypayers and perhaps improving compliance by untrustworthy taxpayers, thus ameliorating the government's budgetary problems.[363] Current determination of the interest charge has the further advantage of permitting a current deduction of the interest, which is more accurate than a delayed deduction.[364] However, the new interest charge is apparently intended to be treated as personal interest,

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[360] 1987 Act, *supra* note 340, § 10202(c) (to be codified at I.R.C. § 453A(c)(1)–(4)).

[361] I.R.C. § 6621(a)(2) (1986).

[362] *See* 1987 Act, *supra* note 340, § 10202(c) (to be codified at I.R.C. § 453A(c)(5)). The conferees state that they anticipate that the regulations "will treat the installment obligations of a partnership as owned directly by the partners in proportion to each partner's share in the partnership." *Conference Report*, *supra* note 355, at H12362.

[363] *See supra* notes 117–18 and accompanying text.

[364] *See supra* notes 52–53 and accompanying text.

which is nondeductible by individual taxpayers.[365] In addition, the interest rate used (the short-term federal rate plus three percentage points) is relatively high.[366] The potential for hardship from this interest charge is, however, greatly reduced by the $5 million threshold for its application.

Use of an assumed tax rate for purposes of determining the amount of the tax deferral loan achieves simplicity by avoiding the need for any recomputation of tax. Complete accuracy (based upon the model of accrual taxation) would require use of the tax rate (or rates) that would have applied to the gain in the years that it accrued. But this is not feasible.[367] The alternative of using the maximum tax rate in effect for each year that the tax deferral loan is outstanding is probably as acceptable as any. Use of this rate may be inaccurate if the maximum tax rate changes from year to year or if the gain would have been taxed at less than the maximum tax rate under accrual rules.[368] However, the latter circumstance may be relatiely uncommon in light of the $5 million threshold for imposing the interest charge.

## APPENDIX

This appendix illustrates the proper application of the Lookback Recomputation Method in cases where there are successive transactions for which deferral is permitted. The principles applied below are described at text accompanying note 216.

Assume the taxpayer begins performance of one three-year contract in 1986 and commences a second three-year contract in 1987. Using the completed contract method, the taxpayer reports his $3,000 profit from each contract entirely in the year of completion. An interest charge is determined under the Lookback Recomputation Method. In the case of each contract, it is

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[365] The conferees state that the interest charge "is treated as interest that is subject to the general rules regarding the deductibility of interest on an underpayment of tax." *Conference Report*, *supra* note 355, at H12362. Interest on an underpayment of individual income tax is classified as personal interest. *See supra* notes 51 & 59. For an argument that the interest charge should either be deductible or be determined at an after-tax interest rate, see *supra* notes 50–51 & 59 and accompanying text.

[366] *See supra* notes 33–79. This rate may be intended to approximate the interest rate that the taxpayer would pay if he were required to borrow from commercial sources to pay the tax currently. *See supra* notes 56–64 & 72.

[367] *See supra* note 341 and accompanying text.

[368] *See supra* notes 245–46 and accompanying text.

determined with hindsight that $1,000 of income was earned in each of the three years of the contract. The tax rate for all years is 10% for the first $20,000 of income, and 20% for any additional income.

*Income and Tax as Shown on Return*

| | *1986* | *1987* | *1988* | *1989* |
|---|---|---|---|---|
| Income from Contract as Shown on Return | $ 0 | 0 | 3,000 | 3,000 |
| Other Income | 20,000 | 19,000 | 17,000 | 20,000 |
| Total Taxable Income | 20,000 | 19,000 | 20,000 | 23,000 |
| Tax Paid | 2,000 | 1,900 | 2,000 | 2,600 |

*Recomputations Made on Completion of First Contract in 1988*

| | *1986* | *1987* | *1988* |
|---|---|---|---|
| Change in Income from First Contract | $ 1,000 | 1,000 | (2,000) |
| Recomputed Taxable Income | 21,000 | 20,000 | 18,000 |
| Recomputed Tax | 2,200 | 2,000 | 1,800 |
| Difference from Actual Tax | 200 | 100 | (200) |

*Consequences*: Taxpayer pays interest on a tax deferral loan of $200 from April 15, 1987, to April 15, 1989, and pays interest on a tax deferral loan of $100 from April 15, 1988, to April 15, 1989. The tax deferral loans are, in effect, repaid to the extent of $200 when the deferred income is reported in 1988. The taxpayer pays the remaining loan balance of $100 on April 15, 1989.

*Recomputations Made on Completion of Second Contract in 1989*

| | *1987* | *1988* | *1989* |
|---|---|---|---|
| Change in Income | $ 1,000 | 1,000 | (2,000) |
| Income as Last Determined | 20,000 | 18,000 | 23,000 |
| Recomputed Taxable Income | 21,000 | 19,000 | 21,000 |
| Recomputed Tax | 2,200 | 1,900 | 2,200 |
| Difference from Last Determined Tax | 200 | 100 | (400) |

*Consequences*: The taxpayer pays interest on a tax deferral loan of $200 from April 15, 1988, to April 15, 1990, and on a tax deferral loan of $100 from April 15, 1989, to April 15, 1990. There is a $100 overpayment of the tax deferral loans when the deferred income is reported in 1989. The Treasury refunds this $100 overpayment on April 15, 1990.

The taxpayer's income for 1987 is recomputed twice, first in 1988 and then in 1989. The first recomputation reflects the inclusion of the $1,000 of income deferred to 1988. By including that income in 1987, the taxpayer's taxable income for 1987 increases from $19,000 to $20,000, and the tax for 1987 increases by $100 from $1,900 to $2,000. The second recomputation reflects the inclusion in 1987 of the $1,000 of income deferred to 1989. This additional income is added to the $20,000 of income for 1987, as previously recomputed, to arrive at income of $21,000. The tax on this amount is $2,200, $200 more than the tax on $20,000. The aggregate amount of the tax deferral loans is $300 ($100 from the first recomputation and $200 from the second recomputation), which is the additional amount of tax that would have been incurred in 1987 if the income from both contracts had initially been reported under the percentage of completion method.

In contrast, the aggregate amount of tax deferral loans would have been understated if the $1,000 of income deferred to 1989 were added to the taxable income for 1987, as originally computed, and the tax on that recomputed taxable income were compared with the actual tax. In that case, the taxable income for 1987, as recomputed in 1989, would be $20,000 and the tax thereon $2,000; this would be $100 more than the actual tax of $1,900. As a result, the aggregate amount of tax deferral loans would have been determined to be $200 ($100 from the 1988 recomputation and $100 from the 1989 recomputation). This would be inaccurate because it would fail to reflect the fact that if the income from both contracts were reported when earned, the last $1,000 of income would have been taxed at a 20% rate rather than at a 10% rate.

Similar considerations apply to the recomputation of taxable income for 1988. The first recomputation, which is made in 1988, reflects the exclusion of the $2,000 of income deferred to 1988 from 1986 and 1987. As a result of the exclusion the taxpayer's taxable income for 1988 decreases from $20,000 to $18,000 and the tax decreases from $2,000 to $1,800. This $200 excess of the tax paid over the tax that would have been paid absent deferral is viewed as repayment of the tax deferral loans granted with respect to income from the first contract.

The second recomputation of tax made in 1989 reflects the inclusion in 1988 of income deferred to 1989. This additional $1,000 of income is added to the taxable income of $18,000 for 1988, as recomputed in 1988, to arrive at a taxable income of $19,000. The tax thereon is $1,900, which is $100 more than the tax on $18,000. This $100 difference is the additional amount of tax that would have been incurred in 1988 by eliminating deferral with respect to the second contract (deferral already having been eliminated with respect to the first contract).

The tax deferral loan would have been overstated if the $1,000 of income deferred to 1989 had been added to the income for 1988 as originally computed ($20,000), and the tax on the recomputed income compared with the tax actually paid ($2,000). In that case the income for 1988 as recomputed in 1989 would have been $21,000 and the tax thereon $2,200. This results in the determination of a tax deferral loan of $200. This would only be accurate on the assumption that the $1,000 of income deferred to 1989 would have been taxed at a rate of 20% if reported in 1988. This assumption is not true, however. If all income from the two contracts had been reported under the percentage of completion method, the total taxable income would have been $19,000; thus, all income would have been taxed at a 10% rate.

# ARTICLE

# CODIFYING A PRIVILEGE FOR SELF-CRITICAL ANALYSIS

DAVID P. LEONARD*

*Organizations often conduct probing self-studies to review internally existing policies and procedures. Despite an increasing social need for these studies, legislatures have not yet constructed a general privilege for self-critical analysis. This hesitation is attributable in large part to the fact that the establishment of evidentiary privileges restricts the flow of information in the litigation process.*

*In this Article, Professor Leonard examines the public interest in a privilege for self-critical analysis, as well as other considerations which have prompted some courts to create a limited privilege and most state legislatures to enact protective legislation for mandated medical review of patient care in hospitals. After concluding that existing privileges do not offer sufficient protection for self-critical analysis, Professor Leonard proposes model legislation to ensure that organizations will continue to conduct self-evaluative studies. Professor Leonard then analyzes each provision in the Model Statute, offering alternative constructions for adoption. Finally, he considers the admissibility of self-critical analyses at trial. Professor Leonard's Model Statute offers guidance to both courts and legislatures as they engage in continuing review of rules governing the litigation process.*

In the last decade, there has been substantial debate concerning the wisdom of establishing a new privilege for self-critical analysis, the internal review of a major policy or procedure conducted by or on behalf of an organization.[1] If the primary

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[1] The academic literature contains several treatments of this privilege. *See, e.g.*, Allen & Hazelwood, *Preserving the Confidentiality of Internal Corporate Investigations*, 12 J. CORP. L. 355 (1987); Crisman & Mathews, *Limited Waiver of Attorney-Client Privilege and Work-Product Doctrine in Internal Corporate Investigations: An Emerging Corporate "Self-Evaluative" Privilege*, 21 AM. CRIM. L. REV. 123 (1983); Flanagan, *Rejecting a General Privilege for Self-Critical Analysis*, 51 GEO. WASH. L. REV. 551 (1983); Murphy, *The Self-Evaluative Privilege*, 7 J. CORP. L. 489 (1982); Weiss, *Who's Watching the Watchdog?: Self-Evaluative Privilege and Journalistic Responsibility in* Westmoreland v. CBS, Inc., 7 COMM./ENT. L.J. 149 (1984); Note, *The Privilege of Self-Critical Analysis*, 96 HARV. L. REV. 1083 (1983) [hereinafter HARVARD Note]; Note, *The Attorney-Client Privilege, the Self-Evaluative Report Privilege, and* Diversified Industries v. Meredith, 40 OHIO ST. L.J. 699 (1979) [hereinafter OHIO STATE Note]; Note, *Discovery of Internal Corporate Investigations*, 32 STAN. L. REV. 1163 (1980) [hereinafter STANFORD Note]; Comment, *Corporate Self-Investigations Under the Foreign Corrupt Practices Act*, 47 U. CHI. L. REV. 803 (1980) [hereinafter CHICAGO

function of the litigation process is to search for truth about past events,[2] then the value and efficacy of such protection against forced disclosure should be carefully assessed. All exclusionary rules of evidence prevent tribunals from learning pertinent facts, and among the rules thought to impede most seriously upon the search for truth are those which establish privileges.[3] The perceived need for "everyman's evidence" motivated Wigmore to suggest stringent criteria for the creation of privileges,[4] and in recent decades courts and legislatures have generally restricted rather than expanded the scope of these rules.[5]

This view of the effect of privileges does not demand, however, that all privileges be eradicated from the law of evidence. Privileges deserve recognition when public interest favors the

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Comment]; Comment, *Civil Procedure: Self-Evaluative Reports—A Qualified Privilege in Discovery?*, 57 MINN. L. REV. 807 (1973) [hereinafter MINNESOTA Comment]; *see also* Block & Remz, *The Confidentiality of Corporate Internal Investigations*, 18 REV. SEC. & COM. REG. 61 (1985); Comment, *Preventing Unnecessary Intrusions on University Autonomy: A Proposed Academic Freedom Privilege*, 69 CALIF. L. REV. 1538 (1981) [hereinafter CALIFORNIA Comment].

Of these works, Professor Murphy's article is noteworthy because, like this Article, it contains proposals for the legislative creation of a privilege for self-critical analysis. However, because I did not wish to be influenced by the specific language of his proposals, I chose not to review those proposals while researching and writing this Article.

[2] *See* In re Dinnan, 661 F.2d 426, 427 (5th Cir. 1981), *cert. denied*, 457 U.S. 1106 (1982); Leonard, *The Use of Character to Prove Conduct: Rationality and Catharsis in the Law of Evidence*, 58 U. COLO. L. REV. 1 (1987).

[3] McCormick wrote that the effect of privileges "is clearly inhibitive; rather than facilitating the illumination of truth, they shut out the light." C. MCCORMICK, EVIDENCE § 72, at 171 (3d ed. 1984) (footnote omitted).

[4] Wigmore proposed that in order to be recognized, a proposed privilege should satisfy "four fundamental conditions":

> (1) The communications must originate in a *confidence* that they will not be disclosed.
>
> (2) This element of *confidentiality must be essential* to the full and satisfactory maintenance of the relation between the parties.
>
> (3) The relation must be one which in the opinion of the community ought to be sedulously *fostered*.
>
> (4) The *injury* that would inure to the relation by the disclosure of the communications must be *greater than the benefit* thereby gained for the correct disposal of litigation.

8 J. WIGMORE, EVIDENCE § 2285 (J. McNaughton rev. ed. 1961) (emphasis in original). Wigmore believed that the attorney-client relationship satisfies these conditions, but that the relationship between physician and patient fails to satisfy both the second and fourth requirements. *Id.*

[5] The scope of the physician-patient privilege, for example, has been narrowly defined by some states. *See, e.g.*, CAL. EVID. CODE §§ 996–1007 (West 1986 & Supp. 1987) (setting forth numerous exceptions to the privilege). The Proposed Federal Rules of Evidence provisions concerning privileges, which Congress later rejected, did not include a specific privilege for communications between physician and patient. *See* FED. R. EVID. 504, advisory committee note (Proposed Draft 1969); *see also* Trammel v. United States, 445 U.S. 40 (1980) (narrowing the application of the common law privilege against adverse spousal testimony).

maintenance of confidentiality in a particular setting,[6] and recent decades have seen the flowering of some privileges[7] and the reaffirmation of other common law privileges by legislatures.[8] Also, privileges exist to foster important values other than the promotion of the free flow of information in certain relationships. For example, privileges often serve a perceived need for privacy—a sense that in some relationships, people have a right to be left alone, even by institutions as fundamentally important as the courts.[9] Privileges also serve to ensure that people have incentives to engage in conduct thought to have important social value. Thus, in an era of diminishing privileges, one must continue to scrutinize the law of privileges to determine if it is sufficiently broad to serve social objectives.

This Article will propose a legislative model for a privilege for self-critical analysis. Part One will discuss the need for the privilege, its underlying purpose, and its place among existing doctrines. Part Two will provide the specific statutory language for the privilege. Part Three will offer commentary on each provision set forth by the Model Statute. Part Four will consider the admissibility of self-critical analyses into evidence at trial. And, finally, the Article will suggest that the Model be adopted by legislatures in order to ensure the continued use of self-evaluative studies by organizations.

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[6] 4 J. MOORE, J. LUCAS & G. GROTHEER, JR., MOORE'S FEDERAL PRACTICE ¶ 26.60[3] (2d ed. 1986). The United States Supreme Court has recognized that privileges can be justified when there is "a public good transcending the normally predominant principle of utilizing all rational means for ascertaining truth." *Trammel*, 445 U.S. at 50.

[7] While the physician-patient privilege has been narrowly construed, the psychotherapist-patient privilege has gained wide recognition in recent decades. *See, e.g.*, In re Lifschutz, 2 Cal. 3d 415, 467 P.2d 557, 85 Cal. Rptr. 829 (1970), where the California Supreme Court stated: "[A] growing consensus throughout the country, reflected in a trend of legislative enactments, acknowledges that an environment of confidentiality of treatment is vitally important to the successful operation of psychotherapy." *Id.* at 422, 467 P.2d at 560–61, 85 Cal. Rptr. at 832–33. Proposed Rule 504 of the Federal Rules of Evidence contains a fairly broad psychotherapist-patient privilege. FED. R. EVID. 504 (Proposed Draft 1969).

[8] *See* CAL. EVID. CODE §§ 911–1060 (West 1986 & Supp. 1987) (codifying many privileges, such as those relating to lawyer-client communications, adverse spousal testimony, marital communications, and physician-patient communications). Congress' rejection of specific rules of privilege in the Federal Rules of Evidence may not represent a view that privileges should be restricted. Indeed, some believe that Congress' intent in enacting Rule 501 was to invest courts with the power to create new privileges. *See* CALIFORNIA Comment, *supra* note 1, at 1540–42.

[9] *See* Louisell, *Confidentiality, Conformity and Confusion: Privileges in Federal Court Today*, 31 TUL. L. REV. 101 (1956); MINNESOTA Comment, *supra* note 1, at 820. Of course, privacy has less social importance in certain settings than in others. Corporations, for example, probably cannot validly claim a right of privacy. Allen & Hazelwood, *supra* note 1, at 356–57.

## I. The Need for a Self-Evaluative Privilege

### A. *The Public Interest Aspect of Self-Critical Analysis*

In recent years, it has become increasingly common for corporations and other organizations to engage in critical self-evaluation.[10] To some extent, the increase in self-critical studies can be attributed to a general social movement toward greater corporate accountability in light of disclosures of illegal corporate practices.[11] Such studies, however, do not always arise from fears that the business may have engaged in illegal conduct. Businesses may simply believe that a full and frank self-evaluation of their operations will be in the public interest.

For example, administrators of a hospital might learn that the institution suffers from a greater than average rate of post-operative mortality. Concerned officials might then decide to conduct an investigation to determine whether hospital personnel are adequately trained in post-operative care, whether policies and procedures are properly designed to meet the acute needs of patients following surgery, and whether hospital personnel adhere to those procedures. To be sure, the study would serve a financial purpose—if the hospital can reduce its post-operative death rate to at least a level which is average for similar institutions, the hospital's potential exposure to tort liability will be minimized. However, the investigation will not only help to limit the cost of delivering medical care, but also will serve a broader social purpose: the adoption and execution of hospital procedures which result in *better* patient care.[12]

If the true purpose of self-evaluation is to uncover all relevant information, including subjective evaluations which could be damaging to the business if revealed, it is natural to inquire whether the legal environment provides sufficient incentives to

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[10] *See* Block & Remz, *supra* note 1, at 61–62; Crisman & Mathews, *supra* note 1, at 124; *cf.* Sporkin, *SEC Enforcement and the Corporate Board Room*, 61 N.C.L. Rev. 435 (1983).

[11] This has been particularly true as corporations during the 1970's were found to have made illegal bribes to foreign officials and engaged in other illegal activities both inside and outside the country. *See, e.g.*, Upjohn Co. v. United States, 449 U.S. 383 (1983); In re Grand Jury Investigation (Sun Oil), 599 F.2d 1224 (3d Cir. 1979); Diversified Indus., Inc. v. Meredith, 572 F.2d 596 (8th Cir. 1977) (en banc).

[12] This is not to say that society does not generally benefit from having more profitable (or at least financially viable) hospitals. The stronger the institution's financial status, the more capable it will be of controlling charges for medical care.

full and frank self-evaluation, or at least does not provide substantial disincentives for businesses to conduct such studies and for persons possessing relevent information to come forward. A number of courts[13] and commentators,[14] and have concluded that at least in some circumstances the possibility that the results of a critical self-study could be discoverable in litigation would chill the self-evaluative process, and that the law should therefore erect at least a partial shield in the form of a discovery privilege. In *Bredice v. Doctors Hospital, Inc.*, which is generally considered to be the first case to recognize the privilege explicitly, the court acknowledged:

> Confidentiality is essential to effective functioning of these [medical review committee] meetings; and these meetings are essential to the continued improvement in the care and treatment of patients. Candid and conscientious evaluation of clinical practices is a *sine qua non* of adequate hospital care. To subject these discussions and deliberations to the discovery process, without a showing of exceptional necessity, would result in terminating such deliberations. Constructive professional criticism cannot occur in an atmosphere of apprehension that one doctor's suggestion will be

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[13] Although federal courts have led the way in the recognition of a privilege for self-critical analysis, *see infra* notes 15–22, some state courts have also recognized the privilege. *See, e.g.*, Tucson Medical Center, Inc. v. Misevich, 113 Ariz. 34, 37–38, 545 P.2d 958, 961–62 (1976); Posey v. District Court, 196 Colo. 396, 398–99, 586 P.2d 36, 37–38 (1978); Dade County Medical Ass'n v. Hlis, 372 So. 2d 117, 118–20 (Fla. Dist. Ct. App. 1979); Oviatt v. Archbishop Bergan Mercy Hosp., 191 Neb. 224, 226–27, 214 N.W.2d 490, 491–92 (1974); Palmer v. City of Rome, 120 Misc. 2d 558, 559–60, 466 N.Y.S.2d 238, 239–40 (Sup. Ct. 1983); Wiener v. Memorial Hosp. for Cancer & Allied Diseases, 114 Misc. 2d 1013, 1015–16, 453 N.Y.S.2d 142, 143–44 (Sup. Ct. 1982). Although most state cases recognizing the privilege have arisen in the limited context of statutes protecting the deliberations of medical review committees, the cases rely heavily on the important public policy of encouraging frank and candid review, and reflect concern that an absence of protection could lead to a significantly impeded review process.

In other cases courts have not been as receptive to the creation of a privilege for self-critical analysis. *See, e.g.*, Jolly v. Superior Court, 112 Ariz. 186, 190–91, 540 P.2d 658, 662–63 (1975); Nazareth Literacy & Benevolent Inst. v. Stephenson, 503 S.W.2d 177, 178–79 (Ky. 1973); Davison v. St. Paul Fire & Marine Ins. Co., 75 Wis. 2d 190, 203–06, 248 N.W.2d 433, 440–42 (1977). Even though some courts have declined to create a privilege, only a small number of state courts have considered the issue, and it is too soon to discern a general trend toward either acceptance or rejection of the concept.

[14] *See, e.g.*, Allen & Hazelwood, *supra* note 1; Block & Remz, *supra* note 1; Murphy, *supra* note 1; Weiss, *supra* note 1; OHIO STATE Note, *supra* note 1; HARVARD Note, *supra* note 1; CALIFORNIA Comment, *supra* note 1; CHICAGO Comment, *supra* note 1.

Other authors have been more skeptical about the need for such a privilege. *See* Flanagan, *supra* note 1; STANFORD Note, *supra* note 1; MINNESOTA Comment, *supra* note 1.

> used as a denunciation of a colleague's conduct in a malpractice suit.[15]

One author identified two distinct chilling effects which the spectre of disclosure may have on the self-evaluative process:

> First, if a plaintiff obtains discovery, there may be a direct chilling effect on the institutional or individual self-analyst; this effect operates to discourage the analyst from investigating thoroughly and frankly or even from investigating at all. . . .
>
> Second, courts should be concerned about the ability of the self-analyst to gather the information that it needs to make its evaluation. Knowledge that a final report may be disclosed will often discourage individuals from coming forward with relevant information.[16]

This rationale has led some courts to declare the existence of a limited privilege in several contexts, including reviews of medical procedures and patient care,[17] post-accident investigations by a railroad company,[18] police department investigations of arrests and shootings,[19] affirmative action studies,[20] confidential peer reviews in the academic setting,[21] and investigations con-

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[15] 50 F.R.D. 249, 250. It has been suggested that one court in a case prior to *Bredice* recognized a possible privilege in this area. In Richards v. Maine Cent. R.R., 21 F.R.D. 593 (D. Me. 1957), plaintiff sued a railroad for the death of an employee in a crossing collision. Plaintiff requested production of documents resulting from investigations made by defendant railroad and filed with the state's Public Utilities Commission pursuant to statute. The court shielded these documents from discovery on the basis that "to require the production of such reports would clearly violate the public policy evidenced by [the statute mandating those reports]. . . ." *Id.* at 594.

[16] HARVARD Note, *supra* note 1, at 1091–92.

[17] In addition to *Bredice*, 50 F.R.D. at 249, see Mewborn v. Heckler, 101 F.R.D. 691 (D.D.C. 1984); Gillman v. United States, 53 F.R.D. 316 (S.D.N.Y. 1971); Dade County Medical Ass'n v. Hlis, 372 So. 2d 117, 118–20 (Fla. Dist. Ct. App. 1979).

[18] *See* Richards v. Maine Cent. R.R., 21 F.R.D. 593 (D. Me. 1957). *But cf.* Jolly v. Superior Court, 112 Ariz. 186, 190–91, 540 P.2d 658, 662–63 (1975) (court refused to create a privilege for safety inspections).

[19] Elliot v. Webb, 98 F.R.D. 293 (D. Idaho 1983); Kott v. Perini, 283 F. Supp. 1 (N.D. Ohio 1968).

[20] Among the many cases which have recognized a privilege in this context are O'Conner v. Chrysler Corp., 86 F.R.D. 211 (D. Mass. 1980); Stevenson v. General Elec. Co., 18 Empl. Prac. Dec. (CCH) ¶ 8777, at 5148 (S.D. Ohio 1978); Rodgers v. United States Steel Corp., 11 Empl. Prac. Dec. (CCH) ¶ 10,666, at 6815 (E.D. Pa. 1975); Sanday v. Carnegie-Mellon Univ., 12 Fair Empl. Prac. Cas. (BNA) 101 (N.D. Pa. 1975); Banks v. Lockheed-Georgia Co., 53 F.R.D. 283 (N.D. Ga. 1971). *But see* Emerson Elec. Co. v. Schlesinger, 609 F.2d 898 (8th Cir. 1979); Reynolds Metals Co. v. Rumsfeld, 564 F.2d 663 (4th Cir. 1977), *cert. denied*, 435 U.S. 995 (1978); Note, *A Balanced Approach to Affirmative Action Discovery in Title VII Suits*, 32 HASTINGS L.J. 1013, 1024–31 (1981).

[21] EEOC v. University of Notre Dame Du Lac, 715 F.2d 331 (7th Cir. 1983); Gray v. Board of Higher Educ., 692 F.2d 901 (2d Cir. 1982) (recognizing a privilege but holding it inapplicable under the facts of the case); Keyes v. Lenoir Rhyne College, 552 F.2d 579, 581 (4th Cir.), *cert. denied*, 434 U.S. 904 (1977); Zaustinsky v. University of Cal.

ducted pursuant to a Securities and Exchange Commission program of voluntary disclosure of information.[22] Although application of the privilege has thus far been limited to cases falling roughly into these areas,[23] there is no reason to suspect that the privilege should be, or will be, so limited in the future.

In addition, widespread concern about the effective functioning of federally mandated medical review of patient care[24] has caused almost all states to enact protective legislation in recent years. Some statutes provide civil immunity to participants in such reviews for their actions as committee members, some provide that certain aspects of the committees' work is not discoverable, and some do both.[25] The scholarly literature also

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at Santa Cruz, 96 F.R.D. 622 (N.D. Cal. 1983), *aff'd*, 782 F.2d 1055 (9th Cir. 1985); McKillop v. Regents of Univ. of Cal., 386 F. Supp. 1270 (N.D. Cal. 1975). *But see* In re Dinnan, 661 F.2d 426 (5th Cir. 1981).

[22] Diversified Indus., Inc. v. Meredith, 572 F.2d 596 (8th Cir. 1977) (en banc); In re LTV Sec. Litig., 89 F.R.D. 595 (N.D. Tex. 1981); Byrnes v. IDS Realty Trust, 85 F.R.D. 679 (S.D.N.Y. 1980); In re Grand Jury Subpoena Dated July 13, 1979, 478 F. Supp. 368 (E.D. Wis. 1979). Although *Diversified Industries* and *In re Grand Jury Subpoena* were technically decided under the attorney-client privilege, the rationale they employed supports the privilege for self-critical evaluation. *See infra* notes 97–106 and accompanying text.

[23] For general discussion of the factual patterns in which the privilege has thus far been applied, see Allen & Hazelwood, *supra* note 1, at 362–63; Crisman & Mathews, *supra* note 1, at 172; Flanagan, *supra* note 1, at 552; HARVARD Note, *supra* note 1, at 1088–90.

[24] *See* 42 U.S.C. § 1320c-1 to -22 (1982). This legislation requires the establishment of a national network of physician groups to review the care rendered to certain groups of patients. *See* A. GOSFIELD, PRSO'S: THE LAW AND THE HEALTH CONSUMER 8–10 (1975). The Joint Commissions on Accreditation of Hospitals (JCAH) created the medical review committees, which seek to improve patient care and treatment. The JCAH's view is that such improvements are facilitated by assuring that hospitals conduct thorough and continuing reviews of their patient treatment. *See* JOINT COMMISSION ON ACCREDITATION OF HOSPITALS, BULLETIN NO. 3, STANDARDS FOR HOSPITAL ACCREDITATION (August 1958).

[25] Those statutes providing civil immunity include: ALASKA STAT. § 18.23.020 (1986); ARIZ. REV. STAT. ANN. § 36-445.02 (1986); ARK. STAT. ANN. § 82-3202 (1976); COLO. REV. STAT. § 12-43.5-103 (1985 & Supp. 1986); GA. CODE ANN. § 31-7-132 (1982); HAW. REV. STAT. § 663-1.7 (1976 & Supp. 1984); IDAHO CODE § 39-1392c (1985); ILL. ANN. STAT. ch. 111 1/2, para. 151.2 (Smith-Hurd Supp. 1986); IND. CODE ANN. § 34-4-12.6-3 (West 1983 & Supp. 1986); KAN. STAT. ANN. § 65-442 (1980); ME. REV. STAT. ANN. tit. 32, § 3293 (1978); MASS. GEN. LAWS ANN. ch. 231, § 85N (West 1985 & Supp. 1986); MINN. STAT. ANN. § 145.63 (West Supp. 1986); MISS. CODE ANN. § 41-63-5 (1972 & Supp. 1986); N.H. REV. STAT. ANN. § 507:8-c (1984); N.J. STAT. ANN. § 2A: 84-22.10 (West Supp. 1986); N.M. STAT. ANN. § 41-9-4 (1986); OHIO REV. CODE ANN. § 2305.25 (Anderson 1981 & Supp. 1986); PA. STAT. ANN. tit. 63, § 425.3 (Purdon Supp. 1986); S.C. CODE ANN. § 40-71-10 (Law. Co-op. 1986); S.D. CODIFIED LAWS ANN. § 36-4-25 (1986); UTAH CODE ANN. § 58-12.43(8) (1986); VT. STAT. ANN. tit. 26, § 1442 (Supp. 1986); VA. CODE ANN. § 54-321.2:1 (Supp. 1986); WASH. REV. CODE ANN. § 4.24.240 (Supp. 1987); W. VA. CODE § 30-3C-2 (1986); WIS. STAT. ANN. § 146.37 (West Supp. 1986); WYO. STAT. § 35-17-103 (1977).

Those statutes preventing discovery include: ALA. CODE § 34-24-58 (1985); ALASKA STAT. § 18.23.030 (1986); ARIZ. REV. STAT. ANN. § 36-445.01 (1986); ARK. STAT. ANN.

contains at least one legislative proposal for a "self-evaluative privilege,"[26] and several proposals have been considered by various committees of the American Bar Association.[27]

### B. *The Need for a Separate Privilege*

Although some materials which would be protected by the privilege for self-critical analysis would also be covered by the attorney-client privilege or the work product doctrine, neither accords sufficient protection to the types of evaluations covered by the proposed Model Statute below.

The attorney-client privilege protects from disclosure any confidential communications between attorney and client relating to the legal matters for which the attorney was consulted.[28] When its foundational requirements are satisfied, and when the client has not waived it, the privilege is absolute; no showing of exceptional need, even on the basis that the information contained in the confidential communication cannot be learned

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§ 82-3204 (1976); CAL. EVID. CODE § 1157 (West Supp. 1987); GA. CODE ANN. § 31-7-133 (1982); HAW. REV. STAT. § 624-25.5 (1976 & Supp. 1984); IDAHO CODE § 39-1392b (1985); IND. CODE ANN. § 34-4-12.6-2 (West 1983 & Supp. 1986); KAN. STAT. ANN. § 65-4915 (Supp. 1984); ME. REV. STAT. ANN. tit. 32, § 3296 (1978); MINN. STAT. ANN. § 145.64 (West Supp. 1986); MISS. CODE ANN. § 41-63-9 (1972 & Supp. 1986); NEB. REV. STAT. § 25-12,123 (1985); NEV. REV. STAT. § 49.265 (1985); N.H. REV. STAT. ANN. § 829:29 (1984 & Supp. 1986); N.J. STAT. ANN. § 2A: 84A-22.8 (West 1976 & Supp. 1986); N.M. STAT. ANN. § 41-9-5 (1986); N.D. CENT. CODE § 31-08-01 (1976 & Supp. 1985); OHIO REV. CODE ANN. § 2305.251 (Anderson 1981 & Supp. 1986); PA. STAT. ANN. tit. 63, § 525.4 (Purdon Supp. 1980); S.C. CODE ANN. § 40-71-20 (Law. Co-op. 1986); S.D. CODIFIED LAWS ANN. § 36-4-26.1 (1986); UTAH CODE ANN. § 58-12.43(7) (1986); VT. STAT. ANN. tit. 26, § 1443 (Supp. 1986); W. VA. CODE § 30-30-8 (1986); WIS. STAT. ANN. § 146.38 (West Supp. 1986); WYO. STAT. § 35-17-105 (Supp. 1986).

Those statutes which both provide civil immunity and prevent discovery include: CONN. GEN. STAT. ANN. § 38-19a (West Supp. 1986); DEL. CODE ANN. tit. 24, § 1768 (1981 & Supp. 1986); FLA. STAT. ANN. § 768.40 (West 1986); IOWA CODE § 147.135 (Supp. 1986); KY. REV. STAT. ANN. § 311.377 (Michie/Bobbs-Merrill 1983); LA. REV. STAT. ANN. § 13:3715.3 (West Supp. 1987); MICH. COMP. LAWS ANN. § 333.16244 (West 1980 & Supp. 1986); MO. REV. STAT. § 537.035 (Supp. 1987); MONT. CODE ANN. § 37-2-201 (1985); N.Y. EDUC. LAW § 6527 (McKinney 1985 & Supp. 1987); N.C. GEN. STAT. § 131E-95 (1986); OKLA. STAT. ANN. tit. 63, § 1-1709 (West 1984); R.I. GEN. LAWS § 23-17-25 (1986); TENN. CODE ANN. § 63-6-219 (1986); TEX. REV. CIV. STAT. ANN. art. 4447d (Vernon 1976 & Supp. 1987); WASH. REV. CODE ANN. § 4.24.250 (Supp. 1987). Only Maryland and Oregon do not have statutes either providing civil immunity or preventing discovery.

For a discussion of the effect of this legislation, see Note, *The Legal Liability of Medical Peer Review Participants for Revocation of Hospital Staff Privileges*, 28 DRAKE L. REV. 692 (1979).

[26] Murphy, *supra* note 1.

[27] *See* Crisman & Mathews, *supra* note 1, at 173–74.

[28] 8 J. WIGMORE, *supra* note 4, § 2292.

by other means, can overcome the privilege.[29] As with most other privileges, the primary theory supporting the need for an evidentiary privilege is instrumental. Without such a privilege, the argument states, there will not be full and frank discussion of all facts in the course of the attorney-client relationship.[30] Although one most often thinks of such a relationship as existing between a single attorney and a single client, it is now clear that the privilege also exists for entities such as corporations.[31] If a corporation relates the results of a self-critical study to its attorney, an opponent in litigation cannot force disclosure of this communication.

Nonetheless, the attorney-client privilege protects only the confidential communication itself. Both the facts learned and the subjective evaluations made in the course of a self-critical study (or the study itself when it is not in fact a communication to the attorney) are therefore not protected by the privilege.[32] Moreover, the self-critical study often will be conducted by outside investigators who might not be considered attorneys for purposes of the attorney-client privilege, even if the investigator is in fact an attorney. This would place all communications made to such individuals outside the scope of the privilege.[33]

There may be times, however, when the somewhat broader work product doctrine will protect self-critical evaluations. That doctrine, which was first recognized by the Supreme Court in *Hickman v. Taylor*,[34] protects from discovery the product of an

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[29] In Diversified Indus., Inc. v. Meredith, 572 F.2d 596 (6th Cir. 1977) (en banc), the court referred to the "long established rule that confidential communications between an attorney and his client are absolutely privileged from disclosure against the will of the client." *Id.* at 601. There is even a restriction on a court's right to view privileged matter. *See* FED. R. EVID. 104(a). However, there are some signs of erosion in the long-standing concept that the attorney-client privilege is absolute. Several years ago, the New Jersey Supreme Court stated that the attorney-client privilege will yield when the evidence is relevant, when there is a legitimate need for it, and when that information cannot be secured from a less intrusive source. Nat'l L. J., March 26, 1979, at 2.

[30] 8 J. WIGMORE, *supra* note 4, § 2291.

[31] *See* Upjohn Co. v. United States, 449 U.S. 383 (1981). Although the Court did not clearly enunciate the contours of the privilege, it did explicitly reject the limited form of privilege usually called the "control group test." For an explanation of the control group test, see City of Philadelphia v. Westinghouse Elec. Corp., 210 F. Supp. 483, 485 (E.D. Pa.), *mandamus and prohibition denied sub nom.* General Elec. Co. v. Kirkpatrick, 312 F.2d 742 (3d Cir. 1962), *cert. denied*, 372 U.S. 943 (1963). Other courts have adopted a more expansive role of the privilege, implementing a "subject matter test." *See* Harper & Row Publishers, Inc. v. Decker, 423 F.2d 487 (7th Cir. 1970), *aff'd per curiam by an equally divided Court*, 400 U.S. 348 (1971).

[32] C. MCCORMICK, *supra* note 3, § 89, at 214.

[33] STANFORD Note, *supra* note 1, at 1169–74.

[34] 329 U.S. 495 (1947).

attorney's trial preparation. As the work-product doctrine was designed in large part to maintain the integrity of the adversary process, the material that it covers can be discovered only in the face of a demonstration of compelling need.[35] If, therefore, a client acting at the request of an attorney for purposes of trial preparation conducts a self-critical study, any information learned as a result of the study, any subjective evaluations emanating from that study, and any report issuing from the work, might be protected from discovery. However, if the study was not prepared in anticipation of litigation, or if preparation for litigation was not the dominant purpose of the study, the work product doctrine will not protect its confidentiality.[36]

Therefore, neither the attorney-client privilege nor the work product doctrine will protect a self-critical evaluation in all cases. While the attorney-client privilege is absolute, it covers only confidential communications. The work product doctrine, by contrast, casts a broader net of coverage, but applies only to work prepared in anticipation of litigation, and gives way in the face of a showing of great need. Yet the policy reasons for encouraging self-critical studies argue for the invocation of a doctrine which offers more protection.[37]

Although courts may possess the power to create new privileges,[38] the increasingly broad recognition of this particular privilege, together with the need for a more uniform approach to its definition and application, suggests the need for the legislative development of the self-evaluative privilege.

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[35] Rule 26(b)(3) of the Federal Rules of Civil Procedure provides that attorney work-product may be discovered "only upon a showing that the party seeking discovery has substantial need of the materials in the preparation of the party's case and that the party is unable without undue hardship to obtain the substantial equivalent of the materials by other means." FED. R. CIV. P. 26(b)(3). *See also* 8 C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE § 2025 (1970).

[36] OHIO STATE Note, *supra* note 1, at 724; STANFORD Note, *supra* note 1, at 1174–76. *See also* In Re Grand Jury Investigation (Sun Oil), 599 F.2d 1224, 1226–27 (3d. Cir. 1979); United States v. Upjohn Co., 600 F.2d 1223, 1224–25 (6th Cir. 1979), *rev'd*, 449 U.S. 383 (1981).

[37] For a general discussion of weaknesses in attempting to apply the attorney-client and work product privileges to cases involving self-critical analyses, see Crisman & Mathews, *supra* note 1; *see also* OHIO STATE Note, *supra* note 1.

[38] Privileges first arose at common law, and the courts' power to create privileges is still recognized. *See* Weiss, *supra* note 1, at 153–54. In addition, Rule 501 of the Federal Rules of Evidence has been interpreted as granting to federal courts the power to create new evidentiary privileges. CALIFORNIA Comment, *supra* note 1, at 1540–42.

## II. Proposed Model Statute

The Model Statute proposed in this Article narrowly defines the privilege in order to ensure that its enforcement does not unduly impede the search for truth in the judicial process. However, as the proposed statute and its commentary make clear, the language used to establish the privilege can be neither so narrow nor so focused as to cover all possible situations in which it might appropriately be applied. That is, the Model Statute cannot create a privilege whose application will be entirely clear upon enactment, and it is expected that the statute's breadth will be defined by judicial application. As is the case with many evidentiary rules,[39] the terms of the rule require the judge to balance specific factors and to reach a conclusion based at least in part on the propriety of applying the privilege under the circumstances of the case. As courts apply the rule over a period of time, its reach will become increasingly clear and the results of its application more predictable.

Bracketed material within the text of the Model Statute constitutes an alternative to the immediately preceding language.

**QUALIFIED PRIVILEGE FOR SELF-CRITICAL ANALYSIS**

**Section (a). (Definitions.) As used in this Statute:**

**1. "Business" includes a business, institution, association, profession, occupation, and calling of every kind, whether or not conducted for profit.**

**2. "Self-critical analysis" is an internal review of a major policy or procedure, conducted by or on behalf of a business' management, and which contains subjective evaluations concerning the policy or procedure.**

**3. "Holder of the privilege" is (A) the business if it is in existence at the time that disclosure is sought; or (B) a successor, assign, trustee, agent, receiver, or any similar representative of the business if the business is no longer in existence at the time that disclosure is sought.**

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[39] *See, e.g.*, FED. R. EVID. 403 (allowing the court to exclude relevant evidence when "its probative value is substantially outweighed by the danger of unfair prejudice, confusion of the issues, or misleading the jury, or by considerations of undue delay, waste of time, or needless presentation of cumulative evidence"); FED. R. EVID. 609(a)(1) (allowing the use of certain prior convictions to impeach a witness' credibility when the court finds "that the probative value of admitting this evidence outweighs its prejudicial effect to the defendant").

Section (b). (Qualified privilege; general rule.) Subject to Section (c), if discovery of a self-critical analysis is sought by any party, the holder, whether or not a party, has a privilege to refuse to disclose, and to prevent another from disclosing, any subjective evaluations contained in the self-critical analysis.

Section (c). (Qualified privilege; order compelling disclosure.) If a claim of privilege is made pursuant to Section (b), the party seeking disclosure may move the court for an order compelling production of the self-critical analysis.

1. Ruling on motion; burden of business against which discovery is sought. The business against which discovery is sought shall have the burden of demonstrating (A) that the document satisfies the definition of self-critical analysis set forth in Subsection (a)(2); and (B) that the self-critical analysis concerns matters which directly serve the public interest.

2. Ruling on motion; burden of party seeking discovery. The party seeking discovery shall have the burden of demonstrating (A) that the information contained in the report is not of a type whose flow would be curtailed if discovery were allowed; and (B) that the party's need for the information in the preparation of the case [substantially] outweighs the public benefit from non-disclosure.

3. Disclosure to court. Should the court find it necessary in order to rule on a motion to compel discovery pursuant to this Subsection, it may require that the holder make available for in camera inspection the self-critical analysis and any related documents sought by the adverse party. Disclosure to the court for this purpose shall not constitute a waiver of the privilege.

Section (d). (Waiver.)

1. General Rule. The privilege is waived to the extent that the holder voluntarily discloses a significant part of the self-critical analysis or consents to such disclosure by anyone, except as necessary to further the goals of the investigation. Consent to disclosure shall be found if the holder acts in a manner inconsistent with an intention to maintain the privilege.

2. Voluntary disclosure to governmental agency. Disclosure of a self-critical analysis to a governmental agency pursuant to a voluntary program of disclosure shall not constitute a waiver of the privilege with respect to other persons or other governmental agencies unless the holder, by conduct or otherwise, manifests an intention not to maintain the privilege. [Voluntary disclosure of a self-critical analysis

**to any governmental agency pursuant to a voluntary program of disclosure shall constitute a waiver of the privilege.]**

**Section (e). (Exception: crime or fraud.) There is no privilege pursuant to this rule if the business undertakes the self-critical analysis in furtherance of an illegal or fraudulent activity.**

## III. Commentary to the Model Statute

### A. *Title*

The title chosen for the privilege, Qualified Privilege for Self-Critical Analysis, reflects two essential aspects of its application. First, the privilege resembles the work product doctrine (which provides protection unless the party seeking disclosure is able to demonstrate a particularly great need) more than the attorney-client privilege (which, once satisfied, does not yield no matter how great the need). Second, the privilege extends only to a business' candid self-evaluation. Other titles for the privilege have been suggested,[40] but the title chosen appears to describe best both its general nature and one of its primary limitations.

Although most authors have used the term "privilege" to describe the nascent doctrine providing qualified protection for self-critical analyses, at least two commentators have suggested caution when using such terminology. One author, writing early in the development of protection for self-critical analyses, stated:

> [T]here are several reasons the protection granted such materials should not be labeled a privilege. First, the problem surrounding self-evaluative reports has arisen almost exclusively in the discovery context. Thus, stating the protection in terms of a privilege may cause confusion because privi-

[40] The Model Statute derives its name largely from that suggested in HARVARD Note, *supra* note 1, at 1086 n.14. That author used the name "privilege of self-critical analysis," and noted some of the many names which have been used to describe the privilege: the "privilege against disclosure of self-evaluative documents" (Emerson Elec. Co. v. Schlesinger, 609 F.2d 898, 907 (8th Cir. 1979)); "qualified privilege for self-evaluative documents" (Reynolds Metals Co. v. Rumsfeld, 564 F.2d 663, 667 (4th Cir. 1977)); "privilege of 'self-critical' analysis" and "defense of self-critical analysis" (Webb v. Westinghouse Elec. Corp., 81 F.R.D. 431, 433 (E.D. Pa. 1978)); and "self-evaluative report privilege" (OHIO STATE Note, *supra* note 1, at 723). Professor Murphy simply uses the term "self-evaluative privilege." Murphy, *supra* note 1.

> leges apply equally at both trial and discovery. Second, the policies supporting restriction of discovery are not always congruent with those supporting the recognition of a privilege at trial.[41]

Another author carefully sought to differentiate between "evidentiary privileges" and "discovery privileges":

> An evidentiary privilege that will prevent admission of certain material at trial operates to prevent discovery as well. . . . A privilege barring pretrial discovery of certain evidence, however, does not compel the exclusion of that evidence at trial. Moreover, the courts apply evidentiary privileges in a more rigid and automatic fashion than discovery privileges whose use depends more on the particular facts of each case.[42]

This author argues that the emerging doctrine would best be labeled a "qualified immunity from discovery," making it analogous to the work product rule.[43] He concludes by noting that "the self-evaluative privilege is not an evidentiary privilege, but rather an exercise in discretionary protection founded in the court's power over discovery."[44]

Although these points are well taken, the general use of privilege terminology in connection with the protection of self-critical analyses, together with careful delineation of the method of its application, suggests that using the privilege label will not cause confusion.

### B. *Section (a): Definitions*

Section (a) defines three terms which are central to the application of the privilege. Subsection (a)(1) defines "business"

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[41] MINNESOTA Comment, *supra* note 1, at 817.

[42] Flanagan, *supra* note 1, at 553 n.12. Professor Flanagan argues that the doctrine has been applied in only limited circumstances and should not be labeled a privilege:

> At most, the coalescing doctrine of the privilege for self-critical analyses provides some protection for self-critical, subjective conclusions such that they need not be produced in civil litigation if sought by private litigants to support claims that the subject of the review acted improperly in the matter under consideration. . . . Given its limited protection, its many exceptions, the undeniable relevance of its information, and the access of the discovering party to its underlying facts, the privilege appears to have an insignificant effect on discovery. Characterizing it as a qualified privilege is a misnomer. To date, the privilege has been asserted only during discovery, and there is no judicial support for its application, as a matter of evidence law, to prevent the admission of self-critical studies at trial.

*Id.* at 573.

[43] *Id.* at 575.

[44] *Id.* at 576.

broadly, adopting language found in the business records exception to the hearsay rule of the Federal Rules of Evidence.[45] By employing this broad definition, the Model Statute makes clear that businesses of any kind, whether or not organized as corporations, and whether or not formed for purposes of making profit, will be permitted to claim the privilege in appropriate circumstances. This definition seems particularly appropriate given the historical development of the privilege for self-critical analysis. As discussed above,[46] the privilege was first explicitly recognized in connection with peer reviews conducted by hospitals,[47] which are often not-for-profit enterprises. The definition would also encompass other types of entities to which the privilege for self-critical analysis has thus far been applied, including educational institutions.

Subsection (a)(2) defines self-critical analysis in a manner intended to make clear that the privilege is at once both broad and narrow in scope. On the one hand, it is broad enough to cover self-critical analysis in widely varying contexts; on the other hand, it is narrow, as not all self-critical analyses will qualify for the privilege. For prima facie qualification, the self-analysis must satisfy three major criteria: (1) it must be internally conducted by or on behalf of management, (2) it must review a major policy or procedure, and (3) it must contain subjective evaluations concerning the policy or procedure being studied.[48]

Several aspects of the definition bear discussion. Often, the self-critical study will be conducted or ordered by top management, but the definition does not require this for several reasons: (1) determination of which persons constitute top management under particular circumstances is often difficult, (2) rejection by the Supreme Court of the control group test for attorney-client privilege[49] suggests that the Court does not believe that the privilege should depend on the precise position of the corporate

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[45] Rule 803(6) of the Federal Rules of Evidence defines "business" to include "business, institution, association, profession, occupation, and calling of every kind, whether or not conducted for profit." FED. R. EVID. 803(6).

[46] *See supra* notes 15 & 17 and accompanying text.

[47] Bredice v. Doctors Hosp., Inc., 50 F.R.D. 249 (D.D.C. 1970), *aff'd*, 479 F.2d 920 (D.C. Cir. 1973).

[48] This definition of self-critical analysis generally tracks the suggestion of Professor Flanagan, who defined a self-critical study "as a review of a major policy or procedure, conducted by or for top management to permit the evaluation and improvement of an organization's operations." Flanagan, *supra* note 1, at 556.

[49] *See* Upjohn Co. v. United States, 449 U.S. 383, 393 (1981).

employee whose communication is at issue, and (3) cases will arise in which a person who clearly does not fit within the category of top management nonetheless has the authority to order or conduct a self-critical study sufficiently important to merit protection. Thus, the term "management" in the definition should be interpreted liberally.

The self-critical study must also concern a major policy or procedure. This part of the definition will ensure that businesses do not impede the discovery process by claiming privileges for studies of minor importance.

Finally, the definition requires that the self-critical analysis contain subjective evaluations of the matter in question. As Section (b) makes clear, only subjective evaluations may be privileged; no protection extends to the data on which such evaluations are based.[50]

Of course, not all self-analyses which satisfy the definition contained in Subsection (a)(2) will necessarily be protected by the privilege. In order to be accorded protection, the provisions of Section (b) must also be satisfied.

Subsection (a)(3) defines the holder of the privilege as the business, if it is in existence when disclosure is sought, or a successor, assign, trustee, agent, receiver, or other representative, if the business itself no longer exists.[51] The holder concept is essential to the law of privilege. However, persons other than the holder may claim the privilege on behalf of the holder. Indeed, as claims of privilege under the Model Statute will primarily arise in the course of discovery proceedings, it will generally be the duty of the attorney to claim the privilege on behalf of the business. Nonetheless, only the holder may waive his right to the privilege.[52]

### C. *Section (b): Qualified Privilege; General Rule*

This section sets forth the basic rule of privilege. The rule vests in the holder of the privilege the right both to refuse to

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[50] To qualify as a self-critical analysis, the study need not contain information or subjective evaluation which would tend to reflect negatively on the business. While businesses will often have little objection to releasing studies which reflect well on their operations (and the privilege is thus not as likely to be asserted in these cases), the privilege does extend to such studies.

[51] The terminology is largely drawn from California's definition of the holder of the attorney-client privilege. *See* CAL. EVID. CODE § 953 (West 1986 & Supp. 1987).

[52] This general concept applies to all privileges. *See, e.g.*, C. MCCORMICK, *supra* note 3, § 93, at 223 (attorney-client privilege).

disclose and to prevent another from disclosing the privileged material.[53] The rule makes clear, however, that the privilege does not embrace an entire self-critical analysis, but only the subjective evaluations contained within. This limitation parallels the case law to date,[54] and has been embraced in the academic literature.[55] Several rationales have been raised in support of the limitation:

> Because the quality of the facts and statistics compiled has no real relationship to the confidentiality fostered by the [privilege], and because their accuracy is readily verifiable and often available notwithstanding the privilege, the rationale behind the privilege is not applicable to this objective type of information. Furthermore, the public has a much greater interest in the disclosure of relevant facts than in gaining access to the subjective evaluations of a source of confidential information.[56]

One reason for protecting only subjective evaluations thus appears to be that the primary purpose behind the privilege—to foster the kind of critical self-evaluations which might not be conducted in the absence of an assurance of confidentiality—applies to subjective evaluation but not to facts. As one author writes, the "chilling effects of disclosure often operate on facts as well as evaluations."[57] Although this criticism appears largely valid, other reasons support the distinction. Principal among them is that the party seeking disclosure may have a great need for particular factual data, which may not be otherwise available. In *Gillman v. United States*,[58] for example, a widow

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[53] The precise language closely parallels that used to create privileges in the California Evidence Code. *See, e.g.*, CAL. EVID. CODE § 954 (West 1986 & Supp. 1987) ("the client, whether or not a party, has a privilege to refuse to disclose, and to prevent another from disclosing, a confidential communication between client and lawyer. . . .").

[54] *See, e.g.*, Webb v. Westinghouse Elec. Corp., 81 F.R.D. 431, 433–34 (E.D. Pa. 1978); Dickerson v. United States Steel Corp., 14 Fair Empl. Prac. Cas. (BNA) 1448, 1449 (E.D. Pa. 1976); Wright v. Patrolmen's Benevolent Ass'n, 72 F.R.D. 161, 164 (S.D.N.Y. 1976); Gillman v. United States, 53 F.R.D. 316, 319 (S.D.N.Y. 1971).

[55] Weiss has stated that "[a] general rule has developed which provides that only subjective conclusions are protected . . . and that statistics and other factual material compiled for the self-evaluation should be disclosed. While it has been criticized, the rule is well established and not without justification." Weiss, *supra* note 1, at 161 (footnotes omitted); *see also* Allen & Hazelwood, *supra* note 1, at 372.

[56] Weiss, *supra* note 1, at 161.

[57] HARVARD Note, *supra* note 1, at 1094. This author also noted that the distinction between facts and evaluation is often vague, and that courts have sometimes drawn the line between the two improperly. *Id.* at 1095–96. In addition, when documents contain both facts and evaluation, excising the evaluative portions can prove complex and costly. *Id.* at 1096.

[58] 53 F.R.D. at 316.

brought suit against the government following the suicide of her husband, who was a patient in a government-run facility. The plaintiff sought production of various documents, including ones which contained factual accounts of the incident by hospital personnel. Denying protection for these documents, the court wrote:

> The statements of Hospital personnel as to what actually happened are important to the plaintiff in her discovery of the facts and to forestall recent contrivance. Statements taken shortly after an occurrence are unique and can never be duplicated precisely. . . . That the decedent is not here to testify or help counsel is also a factor weighing in favor of the plaintiff.[59]

Because the need for factual information may be great, the Model Statute limits the privilege to the subjective elements of a self-critical analysis.[60]

### D. *Section (c): Qualified Privilege; Order Compelling Disclosure*

#### 1. General Principle

Modern procedural reforms permit most routine discovery to take place without substantial court involvement. When documents are sought from a party, the party seeking discovery generally need only serve a request on the other party. Procedural rules then provide for a specified number of days either to produce the materials or to make appropriate objections.[61] Although discovery of documents from a non-party technically requires some court involvement, that involvement is usually very limited. Parties may generally take the depositions of non-

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[59] *Id.* at 319 (citations ommitted).

[60] *See supra* note 54, for cases in which courts have distinguished between subjective and factual material. In some cases a distinction has also been drawn between routine deliberations and analyses conducted in reponse to a particular crisis. The courts adopting this latter distinction have sanctioned protection only for the routine deliberations largely on the basis that they are conducted with an expectation of confidentiality and that such routine reviews might not be conducted if discovery were generally allowed. *See, e.g.*, Bredice v. Doctors Hosp., Inc., 50 F.R.D. 249, 250 (D.D.C. 1970), *aff'd*, 479 F.2d 920 (D.C. Cir. 1973); *see also* CHICAGO Comment, *supra* note 1, at 820–21. The Model Statute does not specifically embrace this standard, but instead, contemplates that a court will weigh the factors in each case. This approach probably will lead to the same results reached by use of the *Bredice* distinction.

[61] *See, e.g.*, FED. R. CIV. P. 34.

parties without formal court order,[62] and if the party taking the deposition wishes the deponent to produce specified documents at the deposition, such production can be compelled by means of a subpoena duces tecum, which the court most often issues as a matter of course.

Only when the party seeking discovery believes that the production was inadequate will the court become wholly involved in the discovery process. To force production, the party must move the court for an order compelling discovery.[63] Both sides will be given an opportunity to present argument on the question of whether discovery should be compelled, and the court will issue an appropriate order.

Section (c) of the Model Statute is intended to track the familiar procedure for seeking and compelling discovery. This Section takes effect when the business which has prepared a self-critical analysis has claimed its privilege pursuant to Section (b) and the party seeking discovery wishes to invoke the court's authority to compel disclosure. Section (c) sets forth the burdens which must be satisfied both by the party seeking discovery and the business against whom discovery is sought. The primary burden rests on the party seeking discovery.

2. Burden on Party that Prepared the Self-Critical Analysis

Subsection (c)(1) sets forth the burden of proof which the business preparing the self-critical analysis must satisfy. The business must meet two conditions. First, under Subsection (c)(1)(A), the business must establish that the document for which it claims a privilege satisfies the definition of self-critical analysis found in Subsection (a)(2). This burden most appropriately falls upon the business, as it prepared the study and therefore has the easiest access to information about the methods of its preparation and the kind of information it contains. Second, under Subsection (c)(1)(B), the business must establish "that the self-critical analysis concerns matters which directly serve the

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[62] *See, e.g.*, FED. R. CIV. P. 30. That rule requires reasonable notice, but does not require leave of court to take the deposition of "any person" except in limited circumstances applicable only to the defendant. Of course, attorneys commonly seek issuance of a subpoena to compel the deponent's attendance, but the rule does not require such a practice. Rule 34(c) of the Federal Rules of Civil Procedure also allows an "independent action" against a non-party for production of documents, though this procedure is not employed very often. FED. R. CIV. P. 34(c).

[63] *See, e.g.*, FED. R. CIV. P. 37(a).

public interest." All evidentiary and procedural devices which shield information from a party, particularly privileges, potentially impede the truth-seeking function of the trial.[64] This is the primary reason behind Wigmore's argument that evidentiary privileges should be created for particular kinds of relationships only where stringent criteria can be satisfied.[65] Although self-critical analyses generally will not arise from the sort of relationships that have given rise to existing privileges,[66] the primary issue raised by both the traditional privileges and the privilege for self-critical analysis remains the same: whether the overall social gain from invoking the privilege overrides the adversary's need for the materials being sought. On this question the courts which have established the privilege for self-critical analysis have been clear.[67] While protecting such studies from disclosure may mean the loss of possibly critical evidence for a litigant,[68] the public gain from preventing disclosure may far outweigh that cost.

It is difficult to generalize about those situations in which a self-critical analysis directly serves the public interest. One criterion may be that the primary purpose of the study must not have been to improve the efficiency of the business.[69] That is, the privilege functions primarily to encourage businesses to conduct self-critical studies which directly serve the public interest.[70] However, because the privilege shields potentially important information from disclosure, it should be available only when absolutely necessary. If, then, the study's primary purpose is to improve the efficiency or profitability of the business, that study will generally be conducted even without protection from subsequent disclosure. The privilege is therefore not needed in such cases.

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[64] *See supra* notes 1–5 and accompanying text.

[65] *See supra* note 4.

[66] Most privileges are designed to protect particularly described relationships, such as husband-wife or clergyman-penitent. *See* FED. R. EVID. 505, 506 (Proposed Draft 1969). The privilege for self-critical analysis, however, does not precisely concern a relationship or status between two persons or entities.

[67] *See* cases cited *supra* notes 13–22.

[68] When the court fully serves its truth-seeking function, both the litigant and the public in general benefit. To deny a litigant access to potentially relevant information not only hurts that litigant, but also erodes society's view of the legitimacy of the courts as institutions which adequately and fairly resolve disputes. *Cf.* Leonard, *supra* note 2.

[69] *See, e.g.*, HARVARD Note, *supra* note 1, at 825.

[70] *See supra* notes 10–27 and accompanying text.

Self-critical studies that do not primarily concern the efficiency of business operations, on the other hand, are far less likely to be conducted without protection. Indeed, these studies may conclude that the business should devote additional resources to matters such as safety which are beneficial to the public. Rather than improving profitability, such steps may adversely impact the business' financial position. Therefore, businesses need confidentiality to ensure the free flow of information and of self-critical conclusions which might result from an analysis. Arguably, society would be in a worse position if such studies were never conducted than it would be if a qualified privilege were accorded to the subjective conclusions reached in the study.[71] Of course, if the primary purpose of a self-critical study is to analyze a matter of public concern, protection will be called for even if the study might have had a secondary effect of making the business more efficient.

The requirement that the study be shown to serve the public interest "directly" is not intended to create a significant hurdle for the business. Nevertheless, a mere secondary salutary effect on the public interest will not suffice. A study primarily intended to make a company's production process more efficient, for example, may well lead to lower consumer prices for the product. Although this may be in the public interest, the achievement of lower consumer prices could be treated as a mere indirect effect of the study, and the business then could not successfully demonstrate that the study directly serves the public interest.

Safety-related studies, such as those designed to improve the safety of a business' products or manufacturing process, or those relating to the quality of care provided to persons who place themselves in the care of the business,[72] will generally satisfy the test of Subsection (c)(1)(B). Because a business' efforts to comply with the law also serves the public interest, self-critical analyses of this aspect of a business' operations will generally satisfy the test as well. Included would be studies of a business' compliance with anti-discrimination laws[73] and other legislation designed to protect individual rights.[74] Beyond these

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[71] If self-critical studies are not conducted, "materials *outside the scope of the privilege* are also not collected." Weiss, *supra* note 1, at 159 (emphasis in original; footnote omitted).

[72] *See* cases cited *supra* note 17.

[73] *See* cases cited *supra* note 20.

[74] *See* cases cited *supra* note 19.

general categories, the determination of whether a self-critical evaluation directly serves the public interest will require a case-by-case analysis. Judicial application of the standard will clarify its meaning and boundaries.

For the same reasons that the business must show that its study satisfies the definition of self-critical analysis, it also should bear the burden of demonstrating that its study directly serves the public interest. The business itself can best explain the purposes and uses of the study and has the easiest access to information about the study's likely impact. The business, however, need only demonstrate that the self-critical analysis is of a type which directly serves the public interest. Then the party seeking disclosure will have the burden of demonstrating that its need for the information in the preparation of its case outweighs the public interest in non-disclosure.

### 3. Burden on Party Seeking Disclosure of Self-Critical Analysis

Subsection (c)(2) establishes the burden which rests with the party seeking production (the moving party). The moving party must make two showings, each of which closely adheres to requirements developed in the case law applying the privilege for self-critical analysis. First, under Subsection (c)(2)(A), the moving party must demonstrate "that the information contained in the report is not of a type whose flow would be curtailed if discovery were allowed." This burden is placed on the party seeking production once the business has shown that the study directly serves the public interest. Such a burden will create neither an insuperable obstacle to the moving party, nor one which forces the moving party to guess the contents of the study. Most likely, the moving party will present general information demonstrating that businesses would conduct similar studies despite the absence of a guarantee of confidentiality. Among the many factors which might be considered in determining whether the moving party has made this showing are whether the report is mandated by legislation or regulation,[75] in which case some

[75] Some cases recognizing the privilege for self-critical analysis have concerned government-required reports. Affirmative action studies, which are required by federal law and regulation in numerous instances, are one example. For cases recognizing a privilege in this context, see *supra* note 20. *See also* HARVARD Note, *supra* note 1, at 1089.

reporting would still occur,[76] and whether the report contains extremely sensitive information, such as frank evaluations of the competency of co-workers or other personnel.[77] Other factors are likely to emerge from judicial application of the test.

The second condition set out by Subsection (c)(2)(B) requires that the party seeking discovery demonstrate that its "need for the information in the preparation of the case [substantially] outweighs the public benefit from non-disclosure." This is perhaps the primary showing which must be made by the moving party in order to overcome the claim of privilege, and will require the application of a case-by-case analysis in light of the facts at issue, the nature of the claim, and the particular self-study involved. Although the lack of specificity in discretionary standards can lead to inconsistent application,[78] the flexibility afforded by such standards allows the courts greater opportunity to view each case in light of its own facts and circumstances and to reach decisions consistent with the goals of justice and the needs of the litigants. Moreover, discretionary standards do not grant unbridled discretion to the trial court. An adjudicable discretionary standard carefully sets forth the factors which

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[76] That the report may be required does not mean, however, that the flow of information would not be curtailed. If confidentiality is not assured, persons interviewed by the business in the preparation of the report may not be as forthcoming as they otherwise would be, and the report's depth may be seriously affected. HARVARD Note, *supra* note 1, at 1091–93. In such cases, the court could find that the flow of information indeed would be curtailed by requiring disclosure of the study.

[77] Such sensitive information is often found in cases involving denial of tenure to university teachers. The privilege for self-critical analysis has been recognized in this context. *See supra* note 21.

[78] The Supreme Court has noted that in order for the purposes of the attorney-client privilege to be served, "[t]he attorney and client must be able to predict with some degree of certainty whether particular discussions will be protected. An uncertain privilege, or one which purports to be certain but results in widely varying applications by the courts, is little better than no privilege at all." Upjohn Co. v. United States, 449 U.S. 383, 393 (1981). The Court then noted that the test for attorney-client privilege in the corporate setting which had been used by the lower court had resulted in "disparate decisions" which illustrated the test's "unpredictability." *Id. See also* Murphy, *supra* note 1, at 496. The arguments for certainty in application appear to be strong with regard to privileges, and per se rules are designed to be applied with the least variation. Nevertheless, the work product doctrine, which operates much like a privilege, has long been constructed as a balancing test. *See* FED. R. CIV. P. 26(b)(3).

Discretionary standards in substantive areas of law, particularly tort law, have also been criticized. *See* Henderson, *Expanding the Negligence Concept: Retreat from the Rule of Law*, 51 IND. L.J. 467 (1976). Others, however, have suggested that properly constructed discretionary standards can be applied consistently. *See* Leonard, *The Good Samaritan Rule as a Procedural Control Device: Is It Worth Saving?*, 19 U.C. DAVIS L. REV. 807 (1986); Twerski, *Seizing the Middle Ground Between Rules and Standards in Design Defect Litigation: Advancing Directed Verdict Practice in the Law of Torts*, 57 N.Y.U. L. REV. 521 (1982).

must be balanced as well as the burdens which must be satisfied by the litigants. With appropriate guidelines, application of discretionary tests is neither insurmountably difficult nor wholly unpredictable. Finally, trial courts are especially familiar with the application of balancing tests in evidentiary and other procedural contexts. Rules of evidence contain numerous provisions requiring trial courts to determine the admissibility of evidence according to such balancing tests,[79] and doctrines such as that protecting attorney work product require similar analysis.[80]

Application of the privilege for self-critical analysis particularly calls for the use of a discretionary standard. The need for caution in the application of a rule excluding relevant evidence, the infinite variety of factual situations in which cases might arise, the unforeseeable circumstances in which claims of privilege will be made, and the peculiar evidentiary posture of each case strongly suggests the need for flexible application. In this respect, the considerations presented by the privilege for self-critical analysis resemble those presented by the work product doctrine.

Under the Federal Rules of Civil Procedure, an attorney's work product will be protected "only upon a showing that the party seeking discovery has substantial need of the materials in the preparation of the party's case and that the party is unable without undue hardship to obtain the substantial equivalent of the materials by other means."[81] Subsection (c)(2)(B) of the Model Statute, however, is even more specific than the work product standard: in addition to requiring that the party show need for the information, the rule explicitly states that the court must balance that need against the interests of the business. As such, the standard should be relatively easy to apply. The primary task of the moving party will be to demonstrate to the court the degree to which the subjective conclusions in the self-critical analysis, the only parts of the analysis subject to the privilege, are needed. Such a showing could be made by demonstrating the centrality of the information to the issues in the case and the unavailability of other evidence which could ade-

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[79] *See, e.g.*, FED. R. EVID. 403, 609; *see also supra* note 39.
[80] FED. R. CIV. P. 26(b)(3).
[81] *Id.*

quately substitute for the otherwise privileged material.[82] Once this has been established,[83] the court will balance the need against the public benefit to be derived from non-disclosure, keeping in mind that the burden rests with the moving party. Some courts applying the privilege for self-critical analysis have embraced similar variations of the balancing test,[84] and such a test has found support in the academic literature.[85]

Subsection (c)(2)(B) offers two alternative standards by which the trial court would measure the moving party's offer. Without adoption of the bracketed word "substantially," the moving party would only have to convince the court that its need for the subjective evaluations slightly outweighs the public benefit from non-disclosure. This test would be analogous to applying the familiar "preponderance of the evidence" standard in the trial of civil cases; the party with the burden need only tip the scales slightly in its favor.[86] The Model Statute favors this stan-

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[82] One commentator has also noted that the showing of need cannot be satisfied by demonstrating only that the information would be "useful" or "helpful," even though such a standard is common in other procedural rules. CALIFORNIA Comment, *supra* note 1, at 1563. The Tenth Circuit, considering the privilege for gathering news, stated that disclosure should be compelled if the party seeking disclosure has been unable to obtain the material from another source, if the information "goes to the heart of the matter," and if it is of "certain relevance." Silkwood v. Kerr-McGee Corp., 563 F.2d 433, 438 (10th Cir. 1977).

[83] A balancing test could be constructed to require separate analysis of the availability of alternative sources of the information. For example, a separate Subsection (c)(2)(C) could be created which requires that the party seeking discovery demonstrate that the information contained in the report cannot reasonably be obtained by means other than disclosure of the self-critical analysis. The Model Statute did not adopt this option because the availability or non-availability of alternative evidence is one of the factors which helps to establish the degree of the moving party's need for disclosure.

[84] *See, e.g.*, Gray v. Board of Higher Educ., 692 F.2d 901 (2d Cir. 1982), *cert. denied*, ___ U.S. ___, 106 S. Ct. 2288 (1986); Jepsen v. Florida Bd. of Regents, 610 F.2d 1379 (5th Cir. 1980); Skibo v. City of New York, 109 F.R.D. 58 (E.D.N.Y. 1985). A balancing test has been at the core of the privilege from its earliest application. In a more general context, Judge Weinstein has enunciated a balancing test for determining when the need for disclosure outweighs the value of confidentiality. United States v. King, 73 F.R.D. 103, 105 (E.D.N.Y. 1976).

[85] *See* CALIFORNIA Comment, *supra* note 1, at 1564. *See also* MINNESOTA Comment, *supra* note 1, at 824 ("[t]he strength of the public interest in non-disclosure depends on both the importance to the public of the evaluative process which is sought to be protected and the extent to which disclosure would impair that process"). There the author suggested that in order to determine the negative effect of disclosure, the court should consider: "1) the magnitude and nature of the requested intrusion; 2) whether there are sufficient independent incentives to undertake self-evaluation even when confidentiality cannot be assured; and 3) the prejudicial effect disclosure would be likely to have on the outcome of the case." *Id.*

At least one author, however, has cautioned against the use of balancing tests both for this privilege and for consideration of the moving party's need. HARVARD Note, *supra* note 1, at 1097–1100.

[86] One treatise defines the "preponderance of the evidence" standard as follows: "[E]vidence preponderates when it is more convincing to the trier than the opposing

dard in recognition of the need for caution in framing rules which might impede the process of truth-determination.

Some jurisdictions may conclude, however, that there is a decreased incentive for self-critical analysis when a business cannot predict with a great degree of certainty whether the privilege would be applicable to a given study. One way to provide greater certainty about the privilege's application would be to increase the burden of proof which must be satisfied by the moving party in order to compel discovery. The Model Statute therefore offers an alternative which provides that the moving party must demonstrate that its need for the subjective evaluations in the study *substantially* outweighs the public benefit from non-disclosure. Application of such a standard would not be a novel task for trial courts, which utilize similar approaches in ruling on certain evidentiary matters.[87] Although such an alternative does not remove all uncertainty from the application of the privilege, it should increase confidence among businesses that subjective evaluations contained in any proposed self-critical studies will remain confidential.

### 4. A Fundamentally Different Alternative Regarding Burdens of Proof

Some legislatures still may not be convinced that the guided discretionary approach to motions to compel will lead to consistent and predictable results. In such instances, the following language may be substituted for Subsections (c)(1) and (c)(2) of the Model Statute:

**1. Ruling on motion. The court shall grant the motion to compel production only if:**

**(A) the business does not demonstrate (i) that the document satisfies the definition of self-critical analysis set forth in Subsection (a)(2), and**

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evidence. . . . The most acceptable meaning to be given to the expression . . . seems to be proof which leads the jury to find that the existence of the contested fact is more probable than its nonexistence." C. McCormick, *supra* note 3, § 339, at 957.

In ruling on procedural and evidentiary matters (such as preliminary questions of fact), courts do not often refer to the quantum of proof which the moving party must offer. However, it is generally understood that unless otherwise specified, the party must only convince the court by evidence and argument satisfying the preponderance standard. 1 D. Louisell & C. Mueller, Federal Evidence § 35 (1977); 1 J. Wigmore, Evidence § 17 n.20 (P. Tillers rev. ed. 1983).

[87] *See, e.g.*, Fed. R. Evid. 403; *supra* note 39.

**(ii) that the self-critical analysis concerns matters which directly serve the public interest; and**

**(B) the moving party demonstrates that the information contained in the report is not of a type whose flow would be curtailed if discovery were allowed.**

In some respects, this alternative would operate similarly to the preferred version of the Model Statute. Under both versions, the business would have the burden of showing that the material satisfies the definition of self-critical analysis and concerns matters which directly serve the public interest. Also, the moving party retains the burden of demonstrating that the information contained in the study is not of the type whose flow would be curtailed if discovery were allowed.

In one respect, however, this alternative fundamentally changes the nature of the privilege. The language of Subsection (c)(2)(B), which set forth the essential balance between the moving party's need for the information and the public benefit from non-disclosure, has been removed entirely from the alternative Subsection (c). This change eliminates much of the court's discretion to review the application of the privilege in light of the particular circumstances of the case.

It is unlikely that different courts would reach varying conclusions about whether a document satisfies the definition of self-critical analysis or whether it concerns matters which directly affect the public interest. And while there may be some disagreement among courts over whether disclosure of a particular type of study would impede the flow of information, this determination does not demand the kind of specific, detailed review of the precise circumstances of the case — including the context in which discovery is sought — which is required in applying the balancing test in the preferred version.

Adoption of the alternative Subsection (c) would thus have both positive and negative consequences. On the one hand, it may have the salutary effect of creating more certainty about the privilege's application, presumably allowing business managers to make more informed decisions about the legal effects of conducting self-critical analyses. On the other hand, however, the court would not have the authority to weigh the circumstances of the case in order to determine the degree of the moving party's need for the information and the public's interest in non-disclosure of a particular study.

Because the alternative Subsection (c) does not require the moving party to demonstrate that its need for the information outweighs the public interest in non-disclosure, application of the alternative Subsection (c) would probably lead courts to compel production more frequently than under the original Subsection (c). Jurisdictions more concerned with the loss of evidence occasioned by the application of privileges may therefore favor the alternative Subsection (c).

### 5. Disclosure to Court

In some situations, the court may find that it cannot render an informed decision on a motion to compel production without inspecting the documents in question. In these cases, the Model Statute provides that the court may require the holder to make the documents available for in camera inspection. This procedure is commonly employed with regard to privileges[88] and has been implemented in several cases involving the privilege for self-critical analysis.[89]

There may be several reasons why the court would find it necessary to conduct an in camera inspection. Such a review might be necessary in order to determine whether the prima facie elements of the privilege have been satisfied, including whether the documents meet the definition of self-critical analysis and whether the documents concern matters which directly serve the public interest. In addition, the court might find it necessary to review the documents in order to determine the strength of the competing considerations specified in Subsection (c)(2). Thus, the court might require review in order to determine the importance of the documents to the party seeking disclosure, as well as the sensitivity of the information and other factors relevant to determining the degree to which non-disclosure would serve the public interest. In some cases in which the court has determined that the privilege applies, in camera inspection may be necessary in order to distinguish subjective evaluations entitled to the privilege from non-privileged mate-

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[88] *See, e.g.*, Kerr v. United States Dist. Court, 426 U.S. 394, 406 (1976); United States v. Nixon, 418 U.S. 683, 714 (1974); Dykes v. Morris, 85 F.R.D. 373, 377 (N.D. Ill. 1980). *See also* 2 D. LOUISELL & C. MUELLER, FEDERAL EVIDENCE § 231 (1978).

[89] EEOC v. University of Notre Dame Du Lac, 715 F.2d 331, 338 (7th Cir. 1983), *cert. denied*, ____ U.S. ____, 106 S. Ct. 2288 (1986); O'Connor v. Chrysler Corp., 86 F.R.D. 211, 218 (D. Mass. 1980); Rosario v. New York Times Co., 84 F.R.D. 626, 631 (S.D.N.Y. 1979).

rial.[90] Whenever the court believes that it is unable to render an adequate decision without reviewing the material, such an inspection should be made.[91]

### E. *Section (d): Waiver*

#### 1. General Rule

As with all privileges, as well as other procedural and evidentiary rights, the privilege for self-critical analysis can be waived. Section (d) specifies the kinds of circumstances in which waiver will occur.

Subsection (d)(1) provides that the privilege is waived if the holder voluntarily discloses or consents to the disclosure of all or a significant part of the self-critical study, except as necessary to further the goals of the investigation. The rule provides further clarification by stating that consent to disclosure will be found when the holder "acts in a manner inconsistent with an intention to maintain the privilege." This rule accords with commonly applied principles of waiver.[92]

As with other privileges, issues will arise concerning whether any disclosure by the business will constitute a waiver. In order to conduct a thorough self-evaluation, businesses must often disclose the results of an ongoing investigation, or a completed study, to various persons for comment and evaluation. If such disclosure takes place to further the goals of the investigation, the court should not hold that the privilege has been waived. Finding a waiver in such circumstances would defeat the goal

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[90] In these latter situations, in camera inspection may well be requested by the party which prepared the self-critical analysis in order to protect it from too broad a disclosure order.

[91] For discussion of the use of in camera inspection in the context of the privilege for self-critical analysis, see Weiss, *supra* note 1, at 161–62; CALIFORNIA Comment, *supra* note 1, at 1567.

[92] *See, e.g.*, CAL. EVID. CODE § 912 (West 1986 & Supp. 1987), providing that a privilege is waived

> if any holder of the privilege, without coercion, has disclosed a significant part of the communication or has consented to such disclosure made by anyone. Consent to disclosure is manifested by any statement or other conduct of the holder of the privilege indicating consent to the disclosure, including failure to claim the privilege in any proceeding in which the holder has the legal standing and opportunity to claim the privilege.

If enacted, Proposed Rule 511 would have provided that a holder waives the privilege if he "voluntarily discloses or consents to disclosure of any significant part of the matter or communication." FED. R. EVID. 511 (Proposed Draft 1969).

of promoting frank, complete self-critical evaluation. In order to prevent such findings, Subsection (d)(1) states that disclosure "necessary to further the goals of the investigation" does not waive the privilege. Businesses, however, cannot invoke the privilege while disclosing portions of a study for commercial or other advantage: "[e]ither the material must be kept completely confidential and undisclosed, except for purposes of furthering the goals of the investigation, or the risk of disclosure must be accepted."[93]

Subsection (d)(1) should be interpreted in light of developing case law with respect to other privileges, especially cases analyzing waiver of the attorney-client privilege upon disclosure to persons outside of the business. In one case involving the attorney-client privilege, the court held that disclosure of an internal investigation to an accounting firm and outside counsel for an underwriter constituted a waiver of the attorney-client privilege.[94] Unless the self-critical analysis was disclosed in order to further the goals of the investigation, the court might also have held that such disclosure waived the privilege for self-critical analysis. By contrast, when an accountant is retained to assist a lawyer in rendering legal services to a business, the attorney-client privilege extends its protection to include confidential communications between the business and the accountant concerning the legal matter.[95] Accordingly, application of the privilege for self-critical analysis should follow this reasoning; waiver should not be found under these circumstances.[96]

### 2. Voluntary Disclosure to a Governmental Agency

Subsection (d)(2) provides that unless the business manifests an intention not to maintain the privilege, voluntary disclosure of the self-critical analysis to a governmental agency will not constitute a waiver of the privilege with respect to other governmental agencies or persons. There has been much contro-

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[93] Allen & Hazelwood, *supra* note 1, at 379 ("no commercial use of self-evaluative privilege materials").

[94] In re John Doe Corp. (Southland) v. United States, 675 F.2d 482, 488–89 (2d Cir. 1982). *See also* United States v. El Paso Co., 682 F.2d 530, 541–42 (5th Cir. 1982), *cert. denied*, 466 U.S. 944 (1984).

[95] United States v. Kovel, 296 F.2d 918, 922 (2d Cir. 1961).

[96] For a discussion of waiver of the attorney-client privilege in this context, see Block & Remz, *supra* note 1, at 65–67; Crisman & Mathews, *supra* note 1, at 153–58.

versy over this issue,[97] particularly with respect to the waiver of the attorney-client privilege. This issue also received much attention when the Securities and Exchange Commission (SEC) established a program of voluntary disclosure during its investigation of illegal corporate payments to foreign officials. Companies under investigation were encouraged to conduct indèpendent self-studies of their practices and to disclose the results of those investigations to the SEC. In return, the government offered lenient treatment for past violations and an opportunity to avoid extended investigation and litigation.[98] Following disclosure to the SEC, however, it was common for others, including civil plaintiffs seeking damage awards against the corporations, to demand disclosure of these studies. In response, courts have reached varying conclusions as to whether disclosure to the SEC waived any privilege.

Some courts developed a doctrine of limited waiver, providing that disclosure to the SEC of investigations which would have been protected by the attorney-client privilege does not operate as a waiver of the privilege in other contexts.[99] This conclusion was based primarily on the view that granting a waiver might discourage cooperation with the SEC.[100] Other courts, however, have refused to recognize the limited waiver doctrine, holding that disclosure to the SEC constitutes a complete waiver of the attorney-client privilege.[101] A few courts have taken a less extreme approach, holding that disclosure constitutes a complete

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[97] *See* Allen & Hazelwood, *supra* note 1, at 363–67; Block & Remz, *supra* note 1, at 66–67; Crisman & Mathews, *supra* note 1.

[98] For a more detailed description of the program, see In re Sealed Case (Tesoro Petroleum), 676 F.2d 793, 800–01 (D.C. Cir. 1982); Crisman & Mathews, *supra* note 1, at 123–26.

[99] The first case to apply this doctrine was Diversified Indus., Inc. v. Meredith, 572 F.2d 598 (8th Cir. 1977) (en banc) (discussed in detail in OHIO STATE Note, *supra* note 1). Other courts have followed the Eighth Circuit's lead. *See, e.g.*, Byrnes v. IDS Realty Trust, 85 F.R.D. 679 (S.D.N.Y. 1980); In re Grand Jury Subpoena Dated July 13, 1979, 478 F. Supp. 368 (E.D. Wis. 1979).

[100] Some courts have reached the same conclusion employing the work product doctrine instead of the attorney-client privilege. *See, e.g.*, In re Grand Jury Investigation (Sun Oil), 599 F.2d 1224, 1228–33 (3d Cir. 1979). In that case, which was decided prior to Upjohn Co. v. United States, 449 U.S. 383 (1981), the court applied the control group test for attorney-client privilege and decided that no privilege existed. It thus examined and found limited protection under the work product doctrine. *See also* In re Grand Jury Subpoena (John Doe, Inc. [Sterling Drug]) v. United States, 599 F.2d 504 (2d Cir. 1979).

[101] *See* Permian Corp. v. United States, 665 F.2d 1214 (D.C. Cir. 1981); *see also* In re Sealed Case (Tesoro Petroleum), 676 F.2d at 824.

waiver unless at the time that disclosure was made the company specifically reserved the right to claim the privilege.[102]

In one case, the court refused to uphold the attorney-client privilege, but stated that permitting discovery of a document previously disclosed to the SEC would run counter to the public interest, as it would discourage the kind of candid internal investigations that the SEC desires.[103] This analysis appears to be an implicit application of the limited waiver doctrine in the context of the privilege for self-critical analysis.[104]

Whether analyzed in terms of the attorney-client privilege, the work product doctrine, or the privilege for self-critical analysis, much confusion currently exists regarding the proper rule for waiver when a business discloses a self-critical study to a governmental agency. Although the Supreme Court's decision in *Upjohn Co. v. United States*[105] can be interpreted as an implicit endorsement of the limited waiver doctrine,[106] the Court did not address the issue, and the law thus stands in a state of discord.

Given these varying views of the waiver question when a business discloses a self-critical study to a governmental agency, the Model Statute proposes two alternatives. The preferred alternative would be to adopt a limited waiver theory.[107] The

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[102] Teachers Ins. and Annuity Ass'n of Am. v. Shamrock Broadcasting Co., 521 F. Supp. 638, 644–45 (S.D.N.Y. 1981); *see also* Schnell v. Schnall, 550 F. Supp. 650, 653 (S.D.N.Y. 1982).

[103] In re LTV Sec. Litig., 89 F.R.D. 595, 619 (N.D. Tex. 1981).

[104] *See* Allen & Hazelwood, *supra* note 1, at 365, who suggest that *LTV Securities Litigation* "bridged the gap between the privilege for internal self-evaluation and the decisions employing the attorney-client privilege. . . ." *See also* Crisman & Mathews, *supra* note 1, at 149, characterizing *LTV Securities Litigation* as having "devised a novel 'hybrid' privilege to protect the materials from civil discovery. . . ."

[105] 449 U.S. 383 (1981).

[106] In reference to *Upjohn v. United States*, Block and Remz state:

> The government had clearly raised the issue of waiver by reason of Upjohn's disclosures to the SEC and IRS. By refraining from holding that the disclosure constituted a general waiver of all communications on the subject, the Court may be seen as endorsing, sub silentio, the limited waiver concept in cases of voluntary disclosure.

Block & Remz, *supra* note 1, at 67 (footnote omitted). Crisman and Mathews agree that the Court impliedly condoned the limited waiver theory. Crisman & Mathews, *supra* note 1, at 143.

[107] The director of the Division of Enforcement of the SEC proposed legislation that would codify the limited waiver rule, at least with regard to the attorney-client and work product contexts. *See* John J. Fedders, *Roundtable: Attorney-Client Privilege in SEC Investigations*, Address at the Annual Meeting of the ABA Section of Corporation, Business and Banking Law (Aug. 8, 1982), *reprinted in* Fed. Sec. L. Rep. (CCH) ¶ 93,242 (1982). In addition, various American Bar Association committees and subcommittees have considered legislative proposals designed for the same purpose. *See* Crisman & Mathews, *supra* note 1, at 173–75, 176–77. In 1984, the SEC proposed legislation to

bracketed alternative provides for the opposite result. Jurisdictions adopting this alternative provision would find waiver whenever a business voluntarily discloses a self-critical analysis to any governmental agency pursuant to a voluntary program of disclosure.[108]

The rationale for this bracketed provision was perhaps most clearly stated in *Permian Corp. v. United States*,[109] the primary case rejecting the limited waiver theory. The *Permian* court appeared to rest its reasoning at least in part on a rationale particularly geared to the attorney-client privilege:

> Voluntary cooperation with government investigations may be a laudable activity, but it is hard to understand how such conduct improves the attorney-client relationship. If the client feels the need to keep his communications with his attorney confidential, he is free to do so under the traditional rule by consistently asserting the privilege, even when the discovery request comes from a "friendly" agency.[110]

The court also rested its conclusion on the ground that businesses should not be able to decide selectively to whom they will disclose otherwise confidential information and when they will claim the privilege for matters that they have already disclosed for their own commercial benefit.[111] Although the court stated at least one other reason for its ruling,[112] one source has

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Congress which specified that production of otherwise privileged materials to the SEC would not constitute waiver of the attorney-client privilege. *See* Block & Remz, *supra* note 1, at 67 n.46 (noting that the SEC proposal had not made headway in Congress, but encouraging the adoption of legislation codifying the limited waiver theory).

[108] Of course, involuntary disclosure to a governmental agency pursuant to a requirement of law should not be treated as a waiver of the privilege. Subsection (d)(1) of the Model Statute makes clear that only voluntary disclosure constitutes a waiver.

[109] 665 F.2d 1214 (D.C. Cir. 1981).

[110] *Id.* at 1221.

[111] The *Permian* court stated:

> The client cannot be permitted to pick and choose among his opponents, waiving the privilege for some and resurrecting the claim of confidentility to obstruct others, or to invoke the privilege as to communications whose confidentiality he has already compromised for his own benefit. . . . The attorney-client privilege is not designed for such tactical employment.

*Id. See also* In re Subpoena Duces Tecum (Fulbright & Jaworski, Vinson & Elkins, and Tesoro Petroleum Corp.), 738 F.2d 1367 (D.C. Cir. 1984).

[112] The court also wrote that no policy inherent in the SEC disclosure program requires changing traditional waiver doctrine: "Important though the SEC's mission may be, we are aware of no congressional directive or judicially-recognized priority system that places a higher value on cooperation with the SEC than on cooperation with other regulatory agencies. . . ." 665 F.2d at 1221.

stated that the corporate manipulation may be the "real basis" for the decision.[113]

The first rationale for rejecting a limited waiver theory, resting on the purposes behind the attorney-client privilege, does not apply to the privilege for self-critical analysis. The self-critical analysis privilege is designed not to foster any particular kind of relationship, but to serve the public interest by encouraging frank self-critical analysis. Moreover, if a governmental agency sees fit to establish a program of voluntary disclosure which carries a reward of avoiding at least some serious sanctions, there is every reason to believe that it has weighed the benefit to be gained from the program against the loss of those sanctions and determined that the benefit of truly frank self-evaluation carries the greatest weight. Although businesses faced with possible governmental sanction in the form of fines or penalties may find it in their best interest to conduct the self-investigations which are part of voluntary disclosure programs, it is doubtful that such studies will be as probing and candid without some assurance of confidentiality as they would be in an environment of limited protection. If another governmental agency determines that a program of voluntary disclosure would be socially beneficial, presumably it can establish such a program. Also, because the Model Statute creates a qualified rather than an absolute privilege, litigants seeking disclosure of self-critical evaluations will have an opportunity to argue that their need for the study outweighs the public benefit to be gained from nondisclosure. Thus, a rule which adopts the limited waiver theory adequately protects the interests of both private litigants and other governmental agencies. Finally, if a company has attempted to manipulate the self-critical analysis privilege for its own commercial purposes, a finding of waiver is justified.

Of course, there will be occasions when a business' conduct in connection with voluntary disclosure does not demonstrate an intention to maintain the privilege. In such cases, as with the general rule of waiver provided in Subsection (d)(1), the court should find that a waiver has occurred. One way in which a business can seek to establish its intention to maintain the privilege as to other parties would be to enter into a stipulation of

[113] "Implicit in the court's decision was its conviction that the Permian Corporation was trying to manipulate the privilege for its own profit," and this can be identified as a major reason for its rejection of the limited waiver theory. Allen & Hazelwood, *supra* note 1, at 867.

confidentiality when disclosing the self-critical study to the governmental agency.[114]

### F. *Section (e): Exception: Crime or Fraud*

Just as there is no legal basis for protecting a party who has consulted an attorney for the purpose of furthering the commission of or helping to conceal a crime or fraud,[115] there is no basis for providing such protection when a self-critical evaluation is prepared for such an improper purpose. Therefore, the Model Statute provides that there is no privilege when the self-critical analysis is undertaken "in furtherance of an illegal or fraudulent activity."[116] Interpretations of the crime or fraud exceptions to the attorney-client and other privileges should guide courts in their application of the exception to the self-critical analysis privilege.

The rationale of *In re Sealed Case (Tesoro Petroleum)*,[117] which analyzed the crime or fraud exception to a privilege in light of the work product doctrine, applies to the privilege for self-critical analysis as well. In *Sealed Case*, corporate officials had conspired to bribe foreign officials and to make illegal domestic campaign contributions. The corporation took part in the

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[114] Allen and Hazelwood suggest that "agreements of confidentiality should be obtained in advance, and materials should not be released without reserving the right to exercise relevant privileges at a later date. These agreements should be as strict as possible, prohibiting disclosure not only to the public, but to other governmental agencies as well." Allen & Hazelwood, *supra* note 1, at 378 (footnotes omitted). Allen & Hazelwood also note that in In re Sealed Case (Tesoro Petroleum), 676 F.2d 793, 824 (D.C. Cir. 1982), the court stated that a governmental agency can agree to limit disclosure of the results of an investigation. Allen & Hazelwood, *supra* note 1, at 378 n.197. *See also* Block & Remz, *supra* note 1, at 70, where the authors suggest that, if possible, the business should either require that the agency return the documents after it has completed its inquiry or that the agency never actually take possession of the documents.

[115] The California Evidence Code provides: "There is no privilege under this article if the services of the lawyer were sought or obtained to enable or aid anyone to commit or plan to commit a crime or a fraud." CAL. EVID. CODE § 956 (West 1986 & Supp. 1987). As proposed to Congress, the Federal Rules of Evidence would have contained an exception providing that there is no privilege "[i]f the services of the lawyer were sought or obtained to enable or aid anyone to commit or plan to commit what the client knew or reasonably should have known to be a crime or fraud. . . ." FED. R. EVID. 503(d)(1) (Proposed Draft 1969).

[116] A specific crime or fraud exception may not be needed because, in such cases, the business would not be able to meet its burden under Subsection (c)(1)(B) of showing that the study directly serves the public interest. Nevertheless, because of its importance and the familiarity which courts and lawyers have with the crime or fraud exception to the attorney-client privilege, the Model Statute contains such an explicit exception.

[117] 676 F.2d 793 (D.C. Cir. 1982).

SEC's voluntary disclosure program, but the government alleged that in conducting its internal investigation, the corporation consulted the lawyers for the purpose of furthering a crime or fraud.[118] The court determined that in order to apply the crime or fraud exception, a two-step inquiry was required: "First, there must be a *prima facie* showing of a violation sufficiently serious to defeat the work product privilege. Second, the court must find some valid relationship between the work product under subpoena and the *prima facie* violation."[119] The court found that the first part of the test could be satisfied with evidence that

> if believed by a trier of fact, would establish the elements of some violation that was ongoing or about to be committed when the work product was prepared. A specific showing of the client's intent in consulting the attorney or the attorney's intent in performing his or her duties is not required. . . .[120]

This first element was satisfied by the possibility that the chairman of the company lied to or tried to mislead the Internal Revenue Service.[121] In reference to the second requirement, the court said that "[a] finding that the work product reasonably relates to the subject matter of the possible violation should suffice,"[122] and that in this case, parts of some unproduced documents related directly to possible criminal violations.[123] The court's analysis in *Sealed Case* provides an accurate roadmap to interpretation of the crime or fraud exception to the privilege for self-critical analysis.[124]

There may be situations in which the conduct of the business in preparing the self-critical analysis does not satisfy the crime or fraud exception but where the public interest would not be served by a recognition of the privilege. In such cases, courts should find that the party seeking production has met its burden under Subsection (c)(2) of the Model Statute.

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[118] *Id.* at 813.
[119] *Id.* at 814–15 (emphasis in original; footnotes omitted).
[120] *Id.* at 815 (footnotes omitted).
[121] *Id.*
[122] *Id.*
[123] *Id.* at 815–16.
[124] *See also* In re John Doe Corp. (Southland) v. United States, 675 F.2d 482, 491 (2d Cir. 1982). For discussion of the application of the crime or fraud exception to self-critical analyses, see Allen & Hazelwood, *supra* note 1, at 369–70; Block & Remz, *supra* note 1, at 68–69; Crisman & Mathews, *supra* note 1, at 158–65.

## IV. The Admissibility of Self-Critical Analyses

A court's decision to compel disclosure of all or part of a self-critical analysis will not determine the admissibility of that document at any subsequent trial or other evidentiary hearing. The standards for discoverability and admissibility at trial are different. In the discovery context, "[i]t is not a ground for objection that the information sought will be inadmissible at trial if the information sought appears reasonably calculated to lead to the discovery of admissible evidence."[125] Thus, the standard for admissibility is more stringent than that for discoverability. To be admissible at the request of either party, the self-critical evaluation must satisfy other evidentiary rules.

There has been little analysis of the admissibility of self-critical evaluations.[126] While a party may seek to introduce a study that is relevant to the issues in the case,[127] several evidentiary rules will probably prevent the admission of self-critical analyses at trial. For example, most courts prohibit the admission of evidence of "subsequent remedial measures," often defined as "measures . . . which, if taken previously, would have made the event less likely to occur."[128] Because many self-critical studies are designed to review past accidents or conditions and to suggest means by which they can be minimized in the future, this rule will apply quite often. While the rule only prohibits the use of such evidence to prove "negligence or culpable conduct," and allows the evidence to be offered to prove such things as "ownership, control, or feasibility of precaution-

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[125] Fed. R. Civ. P. 26(b)(1). This rule does not apply to privileged material; if an item is privileged, it is neither discoverable nor admissible at trial. However, the trial court's decision to grant a motion to compel discovery in this context also determines that the self-critical analysis is not privileged.

[126] In 1983, one commentator noted that the privilege had been asserted only during discovery, and that there was no judicial support for its application at trial. Flanagan, *supra* note 1, at 573.

[127] *See id.* at 558 ("Any evaluation of the self-critical report and its status during discovery must start with the fact that it is undeniably relevant and of assistance in resolving the case."). At times, however, courts have suggested that subjective conclusions in self-critical studies are not relevant. *See* Bredice v. Doctors Hosp., Inc., 50 F.R.D. 249, 251 (D.D.C. 1970), *aff'd*, 479 F.2d 920 (D.C. Cir. 1973) (quoting Richards v. Maine Cent. R.R., 21 F.R.D. 590, 592 (D. Me. 1957)). Such analysis appears to be incorrect.

[128] *See, e.g.*, Fed. R. Evid. 407. *But see* Me. R. Evid. 407 (reversing the general rule and allowing the admission of evidence of subsequent precautions). For a discussion of the application of the subsequent remedial measures rule to self-critical analyses, see Minnesota Comment, *supra* note 1, at 821–23.

ary measures" or to impeach a witness,[129] self-critical studies generally will be offered at trial to prove negligence or culpable conduct. Therefore, they probably will often be inadmissible.

Another evidentiary rule which will operate to prevent the admission of many self-critical studies concerns the use of prior accidents or other similar events to prove either culpable conduct or the existence of a particular condition at a time relevant to the trial. It has been held that parties wishing to offer proof of a prior similar event must demonstrate "substantial identity in the circumstances" between that prior event and the one at issue.[130] Because many self-critical analyses will contain data concerning various accidents or conditions which have existed or occurred over a period of time (as well as suggestions for changes which would minimize future harm), this rule will apply to many studies argued to be privileged.

Related to the "similar happenings" principle are rules designed to prevent the use of character evidence to prove conduct on an occasion of relevance to the case. Courts generally exclude such evidence in civil cases,[131] and admit it only under limited circumstances in criminal cases.[132] Although one generally does not think about the character of a business, the prohibition of character evidence to prove conduct may nevertheless come into play in some situations. For example, in a suit against a corporation for allegedly making illegal payments to foreign officials, plaintiffs may seek discovery and admission of the corporation's self-critical study of its practices. That study may contain factual and evaluative data concerning numerous other actions and, to the extent that the corporation made illegal payments in those situations, the risk exists that the trier of fact will conclude that its past practices continued. If this conclusion can be used as a basis for a finding of liability, the prohibition of character evidence to prove conduct will have been violated. Courts must therefore be aware of possible character-based

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[129] FED. R. EVID. 407.

[130] Robitaille v. Netoco Community Theatres of North Attleboro, 305 Mass. 265, 266, 25 N.E.2d 749, 750 (1940). The court also held that the party seeking admission must show that "the danger of unfairness, confusion or undue expenditure of time in the trial of collateral issues reasonably seems small to the trial judge." *Id.* at 268, 25 N.E.2d at 750. For general discussion of the admissibility of other accidents and injuries, see C. MCCORMICK, *supra* note 3, § 200.

[131] *See* FED. R. EVID. 404(a).

[132] *Id.*

inferences from data and conclusions contained in self-critical analyses.

Sometimes, evidence of prior conduct demonstrates such consistency that it rises to the level of "custom" or "habit." In such cases, evidentiary rules generally permit its admission.[133] It is thus possible that parties seeking admission of certain self-critical analyses will be able to demonstrate that the discussion of incidents or conditions other than those directly at issue would not contravene the rule against offering character evidence to prove conduct.

Other evidentiary rules may provide barriers to the admission of self-critical studies at trial. Trial courts and counsel must be cautioned that a ruling which requires the disclosure of the study for purposes of discovery does not ensure its admissibility; it is anticipated that more often than not the trial court will find the study inadmissible.

## V. Conclusion

Even in an era of increasing scrutiny of evidentiary rules restricting the flow of information to adverse parties and triers of fact, creation of rules which limit the availability of information can sometimes be justified. A carefully crafted privilege for self-critical analysis would satisfy both the law's concern for loss of information and a business' need for confidentiality in its most sensitive reflective acts. If a rule of law affording some protection for self-critical analysis makes corporations more willing to conduct self-evaluative studies, then both the litigation process and society in general will benefit from the existence of such a privilege. Corporations will conduct studies implicating important social goals, such as promotion of safety and conformity to law, and opposing parties will still have the benefit of the objective results of those studies. Additionally, opposing parties may gain complete access to self-evaluative studies upon

[133] *See, e.g.*, FED. R. EVID. 406. The line between character and habit is often difficult to draw. One treatise states that "[c]haracter is a generalized description of a person's disposition, or of the disposition in respect to a general trait, such as honesty, temperance, or peacefulness. Habit . . . is more specific. It denotes one's regular response to a repeated situation. . . . The doing of the habitual act may become semi-automatic." C. MCCORMICK, *supra* note 3, § 195, at 574–75. Evidence of a business' customary practices, if they are reasonably regular and uniform, may be admissible in some courts to an even greater extent than evidence of habit. *Id.* at 576.

the requisite showing of need.[134] The very foundation upon which the privilege rests therefore provides comfort even to those most concerned with the potential loss of data in the trial process.

This Article has attempted to construct a model privilege for self-critical analysis which would serve equally the need for free flow of information in the business setting and in the litigation process. Legislatures are urged to consider adoption of this Model as they engage in continuing review of rules governing the formal adjudication of disputes.

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[134] One commentator has written:

> Implicit in any application of the privilege is an acknowledgement of the self-defeating nature of allowing discovery of frank self-analysis: in the long run, denying protection will stifle more information than will applying the privilege. Refusing to recognize the privilege will thus hinder the flow of information not only to parties seeking protection, but also to the courts themselves. Long-term accessibility to vital information must not be sacrificed on the altar of immediate discovery needs.

HARVARD Note, *supra* note 1, at 1087–88.

# NOTE

# ARTISTS' RIGHTS IN THE UNITED STATES: TOWARD FEDERAL LEGISLATION

MICHAEL E. HOROWITZ*

*Civil law countries have long provided authors and artists with moral and economic rights in their works. These rights include the right not to have the work altered or destroyed, the right to have the artist's or author's name attached to the work, and the right to receive royalties upon resale of the work. United States law does not currently provide artists or authors with a comprehensive system of rights commensurate with that available in civil law countries. Recently, however, legislation has been introduced in both Houses of Congress that would amend United States copyright law to provide artists and authors with many of the rights traditionally available in civil law countries.*

*In this Note, Mr. Horowitz traces the contours of the moral and economic rights provided to artists and authors in civil law countries. He then demonstrates the need for equivalent rights in this country, pointing to the shortcomings of remedies currently available under state and federal law. Mr. Horowitz describes recent efforts to conform United States law to that of civil law countries. The author concludes that federal legislation is desirable and commends recent Congressional bills as an important step toward comprehensive federal protection of artists' rights.*

On August 6, 1987, Senator Edward Kennedy (D-Mass.) introduced S. 1619 (the "Kennedy bill"),[1] an act to amend the United States copyright law to include a provision protecting the moral rights[2] of artists and providing for artists' royalty

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[1] S. 1619, 100th Cong., 1st Sess., 133 CONG. REC. S13,245 (daily ed. Aug. 6, 1987). On August 7, 1987, Representative Edward J. Markey (D-Mass.) introduced a companion bill in the House of Representatives. H.R. 3221, 100th Cong., 1st Sess., 133 CONG. REC. H7352 (daily ed. Aug. 7, 1987); *see also id.* at E3425 (extended remarks of Representative Markey). Both Senator Kennedy and Representative Markey introduced similar bills in the 99th Congress. S. 2796, 99th Cong., 2d Sess., 132 CONG. REC. S12,185 (daily ed. Sept. 9, 1986); H.R. 5722, 99th Cong., 2d Sess., 132 CONG. REC. E3682 (daily ed. Oct. 16, 1986).

[2] The usual understanding of the term "moral rights" is captured in the title of the proposed legislation, indicating that moral rights are designed "to secure the rights of artists of pictorial, graphic, or sculptural works to prevent the distortion, mutilation, or other alteration of such works. . . ." S. 1619, 100th Cong., 1st Sess., 133 CONG. REC. S13,245 (daily ed. Aug. 6, 1987). The term moral rights derives from the French *droit moral*, which encompasses a broader range of rights. *See infra* note 13 and accompanying text.

rights on resale.[3] The Kennedy bill complements similar legislation that was introduced in the House of Representatives in each of the 95th through 98th Congresses.[4]

At a hearing[5] on the initial version of Senator Kennedy's bill as introduced in the 99th Congress, speakers representing a number of different sectors of the art community universally endorsed the idea of federal legislation to protect artists.[6] The general enthusiasm exhibited at the hearing is indicative of a growing recognition among legislators, courts, and academics that American law should provide some protection for artists similar to that provided by the laws of civil law countries. Indeed, within the last ten years three states—California, New York, and Massachusetts—have approved legislation granting limited moral rights to artists.[7] California has gone one step further and granted mandatory resale royalty rights to artists.[8]

This Note analyzes the proposed federal legislation and compares it with the limited protections available to artists under existing law. Part I of the Note gives an overview of the moral rights system as developed in Europe, and outlines the reasons why such a system should be adopted in the United States. Part II details the efforts that have been made in this country to find protections analogous to moral rights either in existing federal statutes or in state common law. Part III analyzes the effectiveness of these American causes of action as substitutes for explicit congressional protection of artists' moral rights. Part IV discusses the three state statutes that currently provide protection for artists' moral rights, and points out the weaknesses in those state laws. Finally, Part V outlines the bills currently pending in Congress and concludes that, despite some flaws, they offer a superior framework for the protection of artists than the existing patchwork of federal and state remedies.

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[3] *See generally* S. 1619, *supra* note 1.

[4] *See infra* notes 274–77.

[5] *Visual Artists Rights Amendment of 1986: Hearing on S. 2796 Before the Subcomm. on Patents, Copyrights and Trademarks of the Senate Comm. on the Judiciary*, 99th Cong., 2d Sess. (1986) [hereinafter *Hearing*].

[6] *See infra* note 35.

[7] CAL. CIV. CODE § 987 (West Supp. 1987); N.Y. ARTS AND CULT. AFF. LAW §§ 11.01, 14.01–.03 (McKinney Supp. 1987); MASS. GEN. LAWS ANN. ch. 231, § 85S (West Supp. 1986).

[8] CAL. CIV. CODE § 986 (West Supp. 1987).

## I. The European System and the Need for an Analogue in American Law

### A. *The* Droit Moral *and the* Droit de Suite *as Developed in Civil Law Countries*

The concept of moral rights for authors and artists, also known as the *droit moral*, is a judicially created doctrine that emerged in France during the period of the French Revolution.[9] The *droit moral* was enacted into French law in 1957,[10] and has been adopted in some format by more than sixty countries.[11] In addition, the Berne Convention for the Protection of Literary and Artistic Works (the "Berne Convention"), the oldest international copyright agreement, contains a moral rights provision.[12]

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[9] *See* DaSilva, *Droit Moral and the Amoral Copyright: A Comparison of Artists' Rights in France and the United States*, 28 BULL. COPYRIGHT SOC'Y U.S.A. 1, 7–9 (1980). The *droit moral* has been described as a "collection of prerogatives, all of which proceed from the necessity of preserving the integrity of intellectual works and the personality of the author." *Id.* at 3 (translating A. LE TARNEC, MANUEL DE LA PROPRIÉTÉ LITTÉRAIRE ET ARTISTIQUE 25 (1966)).

[10] Loi de 11 mars 1957 Sur la Propriété Littéraire et Artistique, 1957 J.O. 2723, 1957 B.L.D. 197 (Fr.) [hereinafter 1957 Law]. The first sentence of the 1957 Law states: "The author of an intellectual work shall, by the mere fact of its creation, enjoy an exclusive incorporeal property right in the work, effective against all parties." U.N. ESCO, COPYRIGHT LAWS AND TREATIES OF THE WORLD, SUPP. 1979–80, Item 1 at 1 (1982) (translating 1957 Law, J.O. at 2723, B.L.D. at 197).

[11] Comment, *Copyright: Moral Right—A Proposal*, 43 FORDHAM L. REV. 793, 797 & n.47 (1975) (citing statutes) [hereinafter *Moral Right Proposal*]; *see also* Comment, *The Monty Python Litigation: Of Moral Rights and the Lanham Act*, 125 U. PA. L. REV. 611, 615 (1977) [hereinafter *Monty Python Litigation*].

[12] *See* Berne Convention for the Protection of Literary and Artistic Works, Sept. 9, 1886, *revised and opened for signature* July 24, 1971, art. 6*bis*, 1972 Gr. Brit. T.S. Misc. No. 23 (Cmnd. 5002) [hereinafter Berne Convention 1971 Revision]. Article 6*bis* currently provides:

> (1) Independently of the author's economic rights, and even after the transfer of the said rights, the author shall have the right to claim authorship of the work and to object to any distortion, mutilation or other modification of, or other derogatory action in relation to, the said work, which would be prejudicial to his honor or reputation.
>
> (2) The rights granted to the author in accordance with the preceding paragraph shall, after his death, be maintained, at least until the expiry of the economic rights, and shall be exercisable by the persons or institutions authorized by the legislation of the country where protection is claimed. However, those countries whose legislation, at the moment of their ratification of or accession to this Act, does not provide for the protection after the death of the author of all the rights set out in the preceding paragraph may provide that some of these rights may, after his death, cease to be maintained.
>
> (3) The means of redress for safeguarding the rights granted by this Article shall be governed by the legislation of the country where protection is claimed.

*Id.* at 6–7.

In its classic formulation the *droit moral* consists of four distinct rights—the right of paternity, the right of integrity, the right of disclosure, and the right of withdrawal.[13] All countries that have incorporated moral rights statutes into their laws include at least some aspects of these four protections,[14] although the exact application varies from country to country.

The right of paternity allows artists to have their name attached to their work.[15] Further, it both prevents others from attributing works to the artist that the artist has not created and prohibits the artist's work from being ascribed to others.[16]

The right of integrity prohibits any distortion or alteration of an artist's work without the artist's permission.[17] In most countries that grant moral rights, the rights of integrity and paternity are inalienable, unassignable, and perpetual.[18]

The right of disclosure allows the artist to decide when a work is complete and ready for release to the public.[19] This right is analogous to the "right of first sale" in United States copyright statutes[20] and the "right of first publication" under the common law of copyright.[21]

The right of withdrawal, conversely, allows the artist to withdraw a work even after it has been brought before the public or sold to another person.[22] Thus, for example, the artist can withdraw the work if it is mistreated by the purchaser or if it is displayed publicly in a manner offensive to the artist. While the right of withdrawal permits the artist to regain an artwork that has left his possession, the artist is required to compensate the individual who is forced to part with the artist's work.

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[13] Krigsman, *Section 43(a) of the Lanham Act as a Defender of Artists' "Moral Rights,"* 73 TRADEMARK REP. 251, 252–53 (1983).

[14] *See* Kwall, *Copyright and the Moral Right: Is an American Marriage Possible?*, 38 VAND. L. REV. 1, 9–10 (1985).

[15] Krigsman, *supra* note 13, at 253. It has been observed that "[s]ince the artist injects his own creative personality into his work, French law vests him with the right to claim authorship of it." DaSilva, *supra* note 9, at 26.

[16] Kwall, *supra* note 14, at 9–10.

[17] *Id.*

[18] Kwall, *supra* note 14, at 12–13.

[19] Rosen, *Artists' Moral Rights: A European Evolution, An American Revolution*, 2 CARDOZO ARTS & ENT. L.J. 155, 159–60 (1983).

[20] 17 U.S.C. § 104 (1982); *see generally* United States v. Atherton, 561 F.2d 747 (9th Cir. 1977) (describing right of first sale under 1909 copyright statute).

[21] *See* M. NIMMER, CASES AND MATERIALS ON COPYRIGHT 105 (1979).

[22] Rosen, *supra* note 19, at 160–61.

In addition to the four components of the *droit moral*, another significant right afforded artists in some European countries is the *droit de suite*.[23] The *droit de suite* secures to artists a percentage of the increase in value of a work whenever it is resold.[24] In this way the *droit de suite* is somewhat analogous to royalties provided to authors by virtue of their ownership of federal copyrights in their works.[25]

The *droit de suite*, like the *droit moral*, was first developed in France,[26] and has since been adopted by a number of other countries.[27] The Berne Convention, in addition to its moral rights provision, contains a clause granting royalty rights to artists.[28]

Both the *droit moral* and the *droit de suite*, as developed in the civil law countries, are grounded in the natural law notion that a work of art is unique to the creator and is a part of his or her personality. Artists should not be forced to sever their relation to their work merely because it is sold. As one commentator has phrased it, "[N]o matter who *owns* it, a work of art still *belongs* in some essential way to the individual who

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[23] 2 M. NIMMER, NIMMER ON COPYRIGHT § 8.22[A] (1987).

[24] *Id.* Roughly translated, the *droit de suite* is "the right of an artist to 'follow' or participate in the proceeds realized from the resale of the tangible embodiment of his work." *Id.*

[25] There is an important difference, however, between royalty rights and the resale rights provided for by the *droit de suite*. While the former is governed by contract, and thus relates only to the first sale of the reproduced work, the latter runs with the artwork, and thus applies to each resale, no matter how removed from the initial sale by the artist. *Id.*

[26] The *droit de suite* was first established in France in 1920, and was revised and incorporated into French law in its current form in 1957. *See* Baldwin, *Art and Money: The Artist's Royalty Problem*, ART IN AM., Mar. 1974, at 20.

[27] Rosen, *supra* note 19, at 163 n.52; Crawford, *Legislation: Art Resale Proceeds Rights*, AM. ARTIST, July 1979, at 82.

[28] Berne Convention 1971 Revision, *supra* note 12, at 11–12. Article 14*ter* states:

> (1) The author, or after his death the persons or institutions authorized by national legislation, shall, with respect to original works of art and original manuscripts of writers and composers, enjoy the inalienable right to an interest in any sale of the work subsequent to the first transfer by the author of the work.
>
> (2) The protection provided by the preceding paragraph may be claimed in a country of the Union only if legislation in the country to which the author belongs so permits, and to the extent permitted by the country where this protection is claimed.
>
> (3) The procedure for collection and the amounts shall be matters for determination by national legislation.

*Id.*, art. 14*ter*, at 11–12.

created it."[29] Thus, artists should have some control over their work regardless of who owns the copyright.[30]

As noted above, certain rights granted to artists in civil law countries are inalienable.[31] This rule is based on a general recognition, discussed more fully below, that artists typically have little bargaining power relative to the purchasers with whom they contract. Thus, artists would be forced to bargain away their rights as a condition of purchase unless the law prevented such rights from being forfeited.

### B. *The Need for Protective Legislation in the United States*

A number of the arguments advanced at the 1986 hearing on the Kennedy bill paralleled those that have been made over the years by a growing number of commentators. One of the most powerful of such arguments is grounded in the well-recognized weak bargaining position of the artist.[32] Primarily due to their

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[29] Boston Visual Artists Union, BVAU NEWS, Nov. 1986, at 1 (emphasis in original). The notion that artists should retain rights in their works even after they are sold can be analogized to arguments that individuals should obtain special property rights as a result of the value they create and the expectations that arise. Considerable controversy has arisen, for example, over whether the employees of a corporation can prevent the corporation from closing plants and abandoning the communities built around the plants. In Local 1330, United States Steel Workers of America v. United States Steel Corp., 631 F.2d 1264 (6th Cir. 1980), the Court of Appeals for the Sixth Circuit affirmed the district court's determination that no property rights had been generated by virtue of United States Steel's longstanding presence in the Youngstown community. The district court, however, had initially stated in a pre-trial hearing:

> [A] property right has arisen from this lengthy, long-established relationship between United States Steel, the steel industry as an institution, the community in Youngstown, the people in Mahoning County and the Mahoning Valley in having given and devoted their lives to this industry. . . . [T]he law can recognize the property right to the extent that U.S. Steel cannot leave that Mahoning Valley and the Youngstown area in a state of waste, that it cannot completely abandon its obligation to that community, because certain vested rights have arisen out of this long relationship and institution.

*Id.* at 1280 (quoting record of pre-trial hearing in district court); *see generally* Millspaugh, *Plant Closings and the Prospects for a Judicial Response*, 8 J. CORP. L. 483 (1983) (outlining theories by which judicial oversight of plant closings has been or might be sought).

[30] Rosen, *supra* note 19, at 176–77.

[31] *See, e.g.*, 1957 Law, *supra* note 10, at 4143. Article 6*bis* of the Berne Convention is silent on the waivability of the *droit moral. See supra* note 12.

[32] "An artist can largely only protect himself if he can succeed in insisting upon contractual provisions; and few artists are in a bargaining position to do that." *Hearing*, *supra* note 5, at 27 (statement of Gustave Harrow). "Knowing how one-sided most negotiations are between artists and art buyers, I would suggest that bill explicitly state that these rights cannot be waived." *Id.* at 123 (statement of Tad Crawford, on behalf of the Graphic Artists Guild Council and the Society of Illustrators and Magazine Photographers); *see also* Damich, *The New York Artists' Authorship Rights Act: A*

substantially below average financial status,[33] artists are usually not in a position to negotiate for the protections that moral rights legislation would provide. Even artists' organizations have been unsuccessful in their efforts to negotiate for standard form purchase contracts that include moral and resale right clauses.[34] As a result, the same organizations are now lobbying for state and federal legislation to provide artists with the rights that they are unable to secure through contractual negotiations.[35] Arguments

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*Comparative Critique*, 84 COLUM. L. REV. 1733, 1745 (1984); DaSilva, *supra* note 9, at 56; Gantz, *Protecting Artists' Moral Rights: A Critique of the California Art Preservation Act as a Model for Statutory Reform*, 49 GEO. WASH. L. REV. 873, 888 n.107 (1981); Merryman, *The Refrigerator of Bernard Buffet*, 27 HASTINGS L.J. 1023, 1043 (1976); Scott & Cohen, *An Introduction to the New York Artists' Authorship Rights Act*, 8 ART & L. 369, 381 (1984); Note, *Protection of Artistic Integrity: Gilliam v. American Broadcasting Companies*, 90 HARV. L. REV. 473, 478 (1976); Comment, *Toward Artistic Integrity: Implementing Moral Right Through Extension of Existing American Legal Doctrines*, 60 GEO. L.J. 1539, 1539 & n.3 (1972) [hereinafter *Toward Artistic Integrity*]; Comment, *The California Art Preservation Act: A Safe Hamlet for "Moral Rights" in the United States*, 14 U.C. DAVIS L. REV. 975, 992 (1981) [hereinafter *Safe Hamlet*]; *cf.* Chafee, *Reflections on the Law of Copyright: II*, 45 COLUM. L. REV. 719, 728 (1945) (arguing that to be of significance, any protection for artists' moral rights must be nonwaivable).

33 Real earnings of artists declined 37% in the 1970's, and the median annual earnings of painters, sculptors, craft artists, and printmakers in 1979 was only $8,576. *Hearing*, *supra* note 5, at 120 (statement of Jack Golodner, Director of the Department for Professional Employees, AFL-CIO).

34 A number of artists' groups have drafted form contracts that contain moral rights provisions. *See* Los Angeles Institute of Contemporary Art, LAICA JOURNAL, Jan.–Feb. 1977, at 36. For example, the Boston Visual Artists Union has developed its own "Standard Transfer and Sale Agreement" (on file at the HARV. J. ON LEGIS.). One of the most widely distributed standard contracts is the Siegelaub-Projansky form agreement, entitled "The Artist's Reserved Rights Transfer and Sale Agreement" (on file at the HARV. J. ON LEGIS.).

35 Among the groups that supported the Kennedy legislation, at least in principle, as it was introduced in the 99th Congress were the AFL-CIO Department of Professional Employees, *Hearing*, *supra* note 5, at 117–18 (statement of Jack Golodner, Director of the Department of Professional Employees, AFL-CIO); the American Institute for Conservation of Historic and Artistic Works, *id.* at 131 (statement of Albert Gilson Brown, President of American Institute for Conservation of Historic and Artistic Works); the American Society of Magazine Photographers, *id.* at 123 (statement of Tad Crawford, on behalf of the American Society of Magazine Photographers); the Bay Area Lawyers for the Arts, *id.* at 43, 123 (resolution of the Bay Area Lawyers for the Arts and statement of Tad Crawford, on behalf of the Bay Area Lawyers for the Arts); the California Confederation of the Arts, *id.* at 44 (statement of Thomas M. Geotzel, professor of law, Golden Gate University, on behalf of the California Confederation of the Arts); the Graphic Artists Guild, *id.* at 123 (statement of Tad Crawford, on behalf of the Graphic Artists Guild); the National Artists Equity Association, *id.* at 122 (statement of James Minden, on behalf of the National Artists Equity Association); the New York Artists Equity Association, *id.* at 144 (statement of Roy Gussow, president of the New York Artists Equity Association); the Society of Illustrators, *id.* at 123 (statement of Tad Crawford, on behalf of the Society of Illustrators); the Visual Artists & Galleries Association, *id.* at 33, 147 (statement and additional submission of Martin Bressler, founder and vice-president of the Visual Artists and Galleries Association, Inc.); and the Volunteer Lawyers for the Arts, *id.* at 91 (statement of John Koegle). Other groups supporting the legislation included the American Council of the Arts and the Boston

in favor of protective legislation generally maintain that rights provided by such legislation should not be waivable by the artist, since the same inequality in bargaining power that now precludes favorable contractual provisions would pressure artists to waive their statutory rights in order to effect a sale.[36]

Additional reasons for moral rights protections stem from the fact that the current copyright law, as was observed at the hearing on the Kennedy bill, protects the economic interests of the copyright owner but not the artistic interests of the creator.[37] The principal justification for the European *droit moral*, that an artwork in some essential way belongs to the artist even after it is sold, has just as much force in the United States as it does in Europe.[38] In addition, since an author's reputation is inex-

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Visual Artists Union. *See* American Society of Magazine Photographers, Inc., ASMP BULLETIN, Aug. 1986, at 4.

[36] The issue of whether to prohibit the contractual waiver of certain rights has been the focus of considerable academic commentary. *See* Rose-Ackerman, *Inalienability and the Theory of Property Rights*, 85 COLUM. L. REV. 931 (1985); Rubin, *Toward a General Theory of Waiver*, 28 UCLA L. REV. 478 (1981); Note, *Enforcing Waivers in Product Liability*, 69 VA. L. REV. 1111 (1983); Note, *Waiver of Rights Under the Age Discrimination in Employment Act of 1967*, 86 COLUM. L. REV. 1067 (1986). Those generally opposed to inhibiting contractual freedom argue that any such prohibition on waiver merely increases the costs to the party purportedly being helped by the prohibition. R. POSNER, ECONOMIC ANALYSIS OF THE LAW 259–62 (1973).

In the moral rights context, there is a split among commentators over waivability. Those supporting a ban on waiver argue that without such a prohibition, the granting of moral rights is merely a charade since artists will be forced contractually to surrender their statutory rights. Chafee, *supra* note 32, at 728; Damich, *supra* note 32, at 1744–45; Gantz, *supra* note 32, at 888–89. Those arguing for permitting waiver point to the need for commercial flexibility in the art market, the possible harm that will result to artists if they are barred from waiving these rights, and the fact that some alterations might be artistically consistent with the creative work. Roeder, *The Doctrine of Moral Right: A Study in the Law of Artists, Authors and Creators*, 53 HARV. L. REV. 554, 570 (1940); Note, *supra* note 32, at 479–80.

[37] *Hearing*, *supra* note 5, at 25 (statement of Gustave Harrow); *see also* Roeder, *supra* note 36, at 576.

[38] *Hearing*, *supra* note 5, at 12 (statement of Alfred Crimi, artist). Mr. Crimi stated:

> A work of fine art is not a replaceable commodity that can be duplicated. It is a one of a kind creation expressing the spirit and mood of the time of its conception and the psychological characteristics of the mind that conceives it. It is an inner expression of the soul that transcends physical appearance. Once destroyed, its spirit cannot be recaptured, not even by the artist who conceived it. Because of its very nature, a work of fine art is a precious expression of the heart and mind of the artists and should be protected.

*Id.* "[A]n artist has a residual interest—a residual right in his or her work of art—in maintaining the integrity of the work. . . ." *Id.* at 20 (statement of Irving Sandler, professor of art history, State University of New York at Purchase); "[T]he creation expresses the artist's inner self, something which cannot be owned. . . . Consequently the rules governing property as such are insufficient. This law would recognize the deep bond between the artist and his or her creation. . . ." *Id.* at 25 (statement of Gustave Harrow).

tricably bound up in the public's perception of the work, any destruction or mutilation of the work equally harms the artist.[39]

A final justification for legislation protecting an artist's right of integrity is that such a right would benefit society by preserving artistic culture in its original form for future generations.[40] A moral rights statute would aid in the preservation of

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[39] Speakers at the 1986 hearing on the Kennedy bill related a number of incidents in which works of art were either mutilated or destroyed without the artists' consent. Professor Rosalind Krauss described an incident in which several sculptures by the American artist David Smith were stripped of paint after his death by the executors of his estate. *Hearing*, *supra* note 5, at 17–18 (statement of Rosalind Krauss, professor of art history, City University of New York); *see also* Kramer, *Alteration of Smith Work Stirs Dispute*, N.Y. Times, Sept. 13, 1974, at 28, col. 1. The alteration of the Smith works was particularly ironic, since before his death Smith had published letters in various art publications protesting the removal of paint from his work "17 H's," disclaiming authorship of the work, and calling for protective legislation. *See, e.g.*, *Letters to the Editor*, ARTS, Summer 1960, at 101. An additional account of destruction was provided by the artist Alfred Crimi, who described how a mural he had been commissioned to create was painted over by the church that had commissioned it because the church found it objectionable. *Hearing*, *supra* note 5, at 12–13 (statement of Alfred Crimi). Mr. Crimi lost his court battle against the church. Crimi v. Rutgers Presbyterian Church, 194 Misc. 2d 570, 89 N.Y.S.2d 813 (Sup. Ct. 1949); *see also infra* text accompanying notes 106–09.

Another startling account was related to the House Subcommittee on Courts, Civil Liberties, and the Administration of Justice during a hearing in the 100th Congress on proposals to adopt the Berne Convention. There the artist William Smith described how a mural he had painted for the state of Maryland was displayed under his signature after it was altered substantially. Molotsky, *Artists Want Work Protected*, N.Y. Times, Oct. 1, 1987, at C21, col. 3. Mr. Smith stated:

> The panel is so desecrated that to this day, seven months later, it is a traumatic experience for me to enter the lobby of Maryland House. My signature remains on a work that is now an embarrassment to my name and reputation.

*Id.* Other incidents have been described. Note, *Artworks and American Law: The California Art Preservation Act*, 61 B.U. L. REV. 1201, 1201 n.1 (1981) (sculpture by Louise Nevelson destroyed by the owner of an inn in Maine in order "to make room for the shrubbery"); Schmidt, *After Auspicious Beginnings, Public Art Finds Itself at Odds with the Public*, N.Y. Times, Nov. 2, 1987, at A16, col. 1 (environmental sculpture on publicly owned property in St. Louis leveled by bulldozers by order of the city parks department). For academic commentary on reputational harm caused to artists by destruction or mutilation of their work, see Gantz, *supra* note 32, at 878; Krigsman, *supra* note 13, at 272.

[40] *Hearing*, *supra* note 5, at 17 (statement of Rosalind Krauss, professor of art history, City University of New York). Professor Krauss stated:

> [T]he logic behind fine arts legislation . . . is a determination to create an exception to the principle of private property, by allowing an artist to sell an object, yet retain aesthetic control over it. A determination which is in turn undergirded by the idea that art transcends the condition of other physical objects because it is somehow the property of a culture. It is our heritage, our patrimony, and its condition is not to be left in the hands of a single owner who, under the terms of private property might change it, cut it up, throw it away, or whatever.

*Id.*

The rationale for moral rights legislation is similar to that advanced by proponents of landmark preservation acts. The right of the states to enact legislation preventing the alteration of landmark buildings was upheld by the Supreme Court in Penn Central Transp. Co. v. City of New York, 438 U.S. 104, 138 (1978), where the Court ruled that artistic culture since it would prevent alteration of an artwork unless the artist consented.

Strong justifications also exist for adding to United States copyright law a resale royalty provision analogous to the European *droit de suite*. Such a provision could be seen as a logical extension of the economic protection currently provided to authors by the copyright law. While authors commonly retain a royalty right in their books and thereby receive considerable financial rewards if their works achieve notoriety, artists under current law collect no pecuniary rewards if the work they sell receives critical acclaim and thereby greatly appreciates in value, even if they continue to hold the copyright in the work.[41] As many commentators pointed out at the Kennedy hearing, this result is particularly inequitable when the appreciation of a work of art is due to the success of subsequent works produced by the artist.[42] A royalty rights provision would create a fairer system whereby at least a portion of the fruits of an artist's ongoing efforts would revert to that artist.[43]

Commentators have also observed that the lack of either a moral rights or a resale royalties provision in American copy-

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the restrictions at issue were "substantially related to the promotion of the general welfare." Existing United States copyright law permits the holder of the copyright to destroy the artwork at will regardless of the potential harm to society. 2 M. NIMMER, *supra* note 23, § 8.21[C].

[41] Baldwin, *supra* note 26, at 20, 22; Price, *Government Policy and Economic Security for Artists: The Case of the* Droit de Suite, 77 YALE L.J. 1333, 1343 (1968).

[42] "For example, had Robert Rauschenberg not continued to develop as an artist and promote his work, his piece 'Thaw' would hardly have appreciated from $900 to $85,000, as in fact it did." *Hearing*, *supra* note 5, at 40 (statement of Thomas M. Geotzel, professor of law, Golden Gate University); *see also id.* at 97 (statement of John Koegle, on behalf of Volunteer Lawyers for the Arts); *id.* at 105 (statement of Thomas M. Goetzel); *see also* Baldwin, *supra* note 26, at 22; Gorewitz, *Artists' Royalties: Should There be a Law?*, ART IN AM., Mar. 1974, at 20, 22. This is apparently the principal rationale behind the French *droit de suite*. See the statement of Thomas M. Goetzel that "in France the appreciation in value enjoyed by a work of art upon its resale is deemed to be largely a consequence of the continuing artistic efforts by the artist." *Hearing*, *supra* note 5, at 40.

[43] An additional argument advanced at the hearing by proponents of the Kennedy bill's resale royalty provision was that such a provision would give artists an economic incentive to create more works and release them to the public. *Hearing*, *supra* note 5, at 92, 98 (statement of John Koegle, on behalf of Volunteer Lawyers for the Arts). A similar argument has been made in support of a moral rights provision. Note, *supra* note 32, at 477 ("an artist's 'moral right' protects both his personal interest in preserving his own artistic integrity *and* his economic interest in maintaining his artistic reputation and thereby the long-run marketability of his work" (emphasis in original)). *But cf.* Weil, *Resale Royalties: Nobody Benefits*, ART NEWS, Mar. 1978, at 58 (arguing that royalty price restrictions on the free market for art will harm, not benefit, artists, since once the market adjusts to those restrictions, either the initial selling price or the overall volume of sales will decline).

right law has been a major obstacle to United States' participation in the Berne Convention.[44] If Congress removes this "sticking point"[45] by enacting the Kennedy bill, then it is likely that the United States would join the majority of nations that are currently signatories to the convention.[46]

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[44] *See* Amarnick, *American Recognition of the Moral Right: Issues and Options*, 29 COPYRIGHT L. SYMP. (ASCAP) 31, 34, 78–79 (1983); Gantz, *supra* note 32, at 877 n.22; THE HISTORY OF U.S.A. COPYRIGHT LAW REVISION FROM 1901 TO 1954, SUBCOMM. ON PATENTS, TRADEMARKS, AND COPYRIGHTS OF THE SENATE COMM. ON THE JUDICIARY, 86TH CONG., 1ST SESS., COPYRIGHT LAW REVISION STUDIES 1–4, 1, 11–12 (Comm. Print 1960) (prepared by A. Goldman, Chief of Research, Copyright Office) [hereinafter COPYRIGHT LAW REVISION STUDY 1]; Nimmer, *Implications of the Prospective Revision of the Berne Convention and the United States Copyright Law*, 19 STAN. L. REV. 499, 518 (1967); *Safe Hamlet*, *supra* note 32, at 976 n.2; Scott & Cohen, *supra* note 32, at 371 n.15; Taubman, *New York Artists' Authorship Rights Act of 1983: Waiver and Fair Use*, 3 CARDOZO ART & ENT. L.J. 113, 121 (1984).

[45] Molotsky, *supra* note 39, at C21, col. 4.

[46] In the last two Congresses, considerable attention has been focused upon the possibility of United States participation in the Berne Convention. As a result, some controversy has arisen over the question whether existing protections of moral rights are sufficient to satisfy the requirements of the convention.

President Reagan submitted the Berne Convention to the Senate for ratification in the 99th Congress. *See* President's Letter of Transmittal to the Senate of the United States, June 18, 1986, *reprinted in* 99th Cong., 2d Sess., 132 CONG. REC. S14,512 (daily ed. Oct. 1, 1986). President Reagan noted that United States accession to the Convention could not be effected until Congress amended the copyright law to make it consistent with the language of the Berne Convention. *Id.* Hearings were held in the 99th Congress on the implications of United States adherence to the Berne Convention. *See U.S. Adherence to the Berne Convention: Hearings on the Implications, Both Domestic and International, of U.S. Adherence to the International Union for the Protection of Literary and Artistic Works Before the Subcomm. on Patents, Copyrights, and Trademarks of the Senate Comm. on the Judiciary*, 99th Cong., 1st & 2d Sess. (1986). In the final days of the 99th Congress, Senator Charles Mathias (R-Md.) introduced a bill that he asserted would amend the copyright law to the minimum extent necessary to conform with the Berne Convention. S. 2904, 99th Cong., 2d Sess., 132 CONG. REC. S14,508 (daily ed. Oct. 2, 1986). The Mathias bill did not, however, contain a moral rights provision. *See id.* at S14,509 (statement of Senator Mathias) ("moral rights are substantially available under U.S. law, although not integrated into the Copyright Act").

On March 16, 1987, Representative Robert Kastenmeier (D-Wis.) introduced a bill containing an express moral rights provision. H.R. 1623, 100th Cong., 1st Sess., 133 CONG. REC. H1293, H1295 (daily ed. Mar. 16, 1987). On May 29, 1987, Senator Patrick J. Leahy (D-Vt.) introduced another bill seeking to implement the Berne Convention. S. 1301, 100th Cong., 1st Sess., 133 CONG. REC. S7369 (daily ed. May 29, 1987). The Leahy bill contains no moral rights provision. Senator Leahy took the position that existing law provided sufficient protection to artists to satisfy the strictures of the Berne Convention, *id.* at S7370–71, and that debate over an express moral rights provision would only be "a contentious distraction from the effort to bring the United States into the Berne Convention," *id.* at S7371.

On July 15, 1987, Representative Carlos J. Moorehead (R-Cal.) introduced a Berne Convention implementation bill on behalf of the Reagan Administration. H.R. 2962, 100th Cong., 1st Sess., 133 CONG. REC. E2897 (daily ed. July 15, 1987). Explaining the bill's failure to provide for express moral rights, Representative Moorehead stated:

> The administration bill proceeds from the assumption that the totality of U.S. law, including the right to prepare derivative works under the copyright law, the Lanham Act's proscription of false designation of origin—section 43(a)—and common law rights of contract and tort—especially defamation and inva-

## II. RECENT EFFORTS TO SECURE PROTECTION FOR ARTISTS WITHIN EXISTING LEGAL FRAMEWORKS

In this country, no comprehensive system comparable to the *droit moral* or the *droit de suite* of the civil law countries exists. Rather, artists are left to seek remedies in existing state and federal law. While some artists have been successful in establishing such rights, the result is a patchwork of discrete protections that is understandably arbitrary, since the protections derive from areas of the law not designed with artists' protection specifically in mind.

### A. *Remedies Under Existing Federal Copyright Law*

Article I, Section 8 of the United States Constitution grants Congress the power to provide copyright protection in order to "promote the Progress of Science and useful Arts."[47] The Supreme Court has stated that the aim of the copyright law is to "stimulate artistic creativity for the general public good."[48] Certainly, it would be within Congress' copyright power to enact an artists' moral and resale rights statute. To date, however, none of the moral rights or resale royalty proposals introduced in the Senate or the House has been successful. Some artists nonetheless have sought protection for their works directly under existing United States copyright laws.[49]

Perhaps the most significant case to date recognizing an analogue to an artist's right of integrity under the current copyright laws is *Gilliam v. American Broadcasting Cos.*[50] In *Gilliam*, members of the British comedy group "Monty Python" sought

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sion of privacy—provide protection for the rights of paternity and integrity sufficient to comply with the Berne Convention.

*Id.* at E2897.

The Subcommittee on Courts, Civil Liberties and the Administration of Justice of the House Committee on the Judiciary recently held a hearing on whether Congress should adopt the convention with the moral rights provision, adopt it without the provision, or adopt it without the provision but pass a separate moral rights law. *Hearing on H.R. 1623 before the Subcomm. on Courts, Civil Liberties and the Administration of Justice of the House Comm. on the Judiciary*, 100th Cong., 1st Sess. (1987) (unofficial transcript on file at the HARV. J. ON LEGIS.) [hereinafter *Hearing on H.R. 1623*]; *see also* Molotsky, *supra* note 39 at C21, col. 4.

[47] U.S. CONST. art. I, § 8, cl. 8.

[48] Sony Corp. of America v. Universal City Studios, Inc., 464 U.S. 417, 432 (1984) (quoting Twentieth Century Music Corp. v. Aiken, 422 U.S. 151, 156 (1975)).

[49] Kwall, *supra* note 14, at 39–56.

[50] 538 F.2d 14 (2d Cir. 1976).

to prevent the ABC television network from broadcasting an edited version of a television series that the group had originally produced for the British Broadcasting Corporation (BBC). The Monty Python group had written the script for the series pursuant to a contract between the group and the BBC that sharply limited the BBC's power to edit the script prior to recording the show. In addition, the contract required that strict procedures be followed during the editing process.[51] Although the group retained all rights in the script, the agreement was silent as to whether the program could be altered once it was recorded.[52]

After recording the show, the BBC entered into a separate agreement with ABC that allowed ABC to broadcast two ninety minute specials of the group's shows, each to be comprised of three thirty minute episodes. Although the BBC believed that ABC would broadcast the shows in their entirety,[53] ABC proceeded to cut twenty-four minutes from the first ninety minute production in order to remove material that was considered offensive and to leave room for commercials.[54] Following the first ABC broadcast, the Monty Python group sought an injunction preventing ABC from broadcasting the second special.[55]

In a preliminary evidentiary hearing, United States District Judge Morris Lasker found that the group had "established an impairment of the integrity of their work" that had "caused the film or program . . . to lose its iconoclastic verve."[56] Despite a finding of irreparable harm,[57] the district court denied the group's motion for a preliminary injunction in part because the court was unable to determine who owned the copyright in the television shows produced from the Monty Python scripts.[58]

The district court did order ABC to put a disclaimer at the beginning of the second special stating that the group did not approve of the network's editing.[59] However, the Court of Appeals for the Second Circuit stayed the district court's order,

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[51] *Id.* at 17 n.2 ("When script alterations are necessary it is the intention of the BBC to make every effort to inform and to reach agreement with the Writer" (quoting agreement between BBC and the Monty Python group).).

[52] *Id.*

[53] *Id.* at 18.

[54] *Id.* The court did not indicate how much of ABC's editing was for censorship reasons and how much for commercial reasons.

[55] *Id.*

[56] *Id.* (quoting district court).

[57] *Id.*

[58] *Id.*

[59] *Id.*

and instead required ABC to broadcast a statement at the show's outset that the program had been edited by ABC.[60] Thus, on December 26, 1975, ABC aired the second edited Monty Python special, despite the "irreparable"[61] damage it would likely cause to the group's reputation.

In a subsequent decision on the merits, handed down over six months after the airing of the second show, the Court of Appeals ruled in favor of the Monty Python group and directed the district court to issue a preliminary injunction, basing its decision in part on the federal copyright laws.[62] As an initial matter, the court held that the Monty Python group had an independent copyright in the script upon which the television show was based.[63] As such, the question of who owned the copyright in the television show was irrelevant. Even if the BBC owned the television copyright, its use of the work would be limited by the license granted to the BBC by Monty Python for the use of the underlying script.[64] The court further found that the "scriptwriters' agreement explicitly retain[ed] for the group all rights not granted by the contract,"[65] and that the BBC "was not specifically empowered to alter the recordings once made."[66] Since the BBC did not have authority to edit the recordings it could not "convey greater rights than it own[ed]."[67] Thus, any purported transfer by the BBC to ABC of a right to edit the script was "a nullity."[68] While the court recognized that "licensees are entitled to some small degree of latitude in arranging the licensed work for presentation to the public,"[69] it determined

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[60] *Id.*

[61] *Id.*

[62] *Id.* at 19–24, 26. The Court of Appeals also based its decision upon § 43(a) of the Lanham Act. *See infra* notes 82–92 and accompanying text.

[63] *Gilliam*, 538 F.2d at 19–20.

[64] *Id.* at 19.

[65] *Id.* at 22.

[66] *Id.* at 21. The group had granted the BBC the right to license the broadcasts in any overseas territory. *Id.* at 17. The court apparently did not read into the license agreement the right to edit for commercials, as did the court in Preminger v. Columbia Pictures Corp., 49 Misc. 2d 363, 367, 267 N.Y.S.2d 594, 600 (Sup. Ct.), *aff'd*, 25 App. Div. 2d 830, 269 N.Y.S.2d 913, *aff'd*, 18 N.Y.2d 659, 219 N.E.2d 431, 273 N.Y.S.2d 80 (1966).

[67] *Gilliam*, 538 F.2d at 21.

[68] *Id.*

[69] *Id.* at 23. The court did not attempt to fashion a precise test to determine when a given alteration would be deemed de minimus. Although ABC's alteration was at least in part for the purpose of including commercials, it was nonetheless considered by the court to be substantial. Thus it would appear that under *Gilliam*, a claim by a network that it needed to alter a show for commercial purposes would not be a per se defense to an infringement action where the creator retained the rights in the underlying work. *But cf. Preminger*, 49 Misc. 2d at 367, 267 N.Y.S.2d at 600 ("implicit in the grant of

that ABC's deletion of twenty-seven percent of the show exceeded any permissible level.[70]

The copyright holding in *Gilliam* stood dormant for six years until the decision in *WGN Continental Broadcasting Co. v. United Video, Inc.*[71] In *WGN*, the Court of Appeals for the Seventh Circuit was faced with a claim by "superstation" WGN that the cable television distributor of its evening news show, United Video, had violated its copyright by deleting material included in the "vertical blanking interval" of the program (known as "teletext").[72] The WGN teletext contained news stories and the station's program schedule, and appeared in place of the news show when the cable viewer pushed a decoder button on the cable box.[73] United Video replaced WGN's teletext with a Dow Jones teletext of business news.[74]

The Seventh Circuit upheld WGN's claim, reasoning that because the teletext was transmitted along with the news show it was covered by the same copyright.[75] Judge Posner, writing for a unanimous court, drew an analogy to copyrights covering materials not designed to be viewed or read consecutively or simultaneously, such as pages of a dictionary or a fold-out map in a book.[76] The court concluded that "the deletion of the teletext from United Video's retransmission was an alteration of a copyrighted work and hence an infringement under familiar principles."[77]

The holding in *WGN* that alteration equals copyright infringement goes far beyond the holding of *Gilliam*.[78] In *Gilliam*, a full twenty-seven percent of the Monty Python program had been deleted, and both the trial and appellate courts found that the work's integrity had been severely damaged. No such finding

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television rights is the privilege to cut and edit"). *Gilliam* suggests that the issue of infringement is determined by the extent of, not the rationale for, a given alteration. *Gilliam*, 538 F.2d at 23.

[70] *Gilliam*, 538 F.2d at 23.

[71] 693 F.2d 622 (7th Cir. 1982).

[72] Judge Posner described in detail the "vertical blanking interval" and the process by which teletext is generated. *Id.* at 623–24, 628.

[73] *Id.* at 624.

[74] *Id.*

[75] *Id.* at 626.

[76] *Id.* at 626–27.

[77] *Id.* at 625. The court cited only the *Gilliam* decision for the "familiar principles" that it asserted. *Id.*

[78] *See* Barnett, *From New Technology to Moral Rights: Passive Carriers, Teletext, and Deletions as Copyright Infringement—The* WGN *Case*, 31 J. COPYRIGHT SOC'Y U.S.A. 427, 437–41 (1984).

of damage was made in *WGN* in support of the Seventh Circuit's holding of copyright infringement.[79]

Some commentators viewed *Gilliam* and *WGN* as providing hope for those seeking to establish the *droit moral* through the copyright laws of the United States.[80] However, as will be discussed more fully below, the two cases have proved of limited significance in establishing moral rights protection.[81]

### B. *Moral Rights Protection Under Section 43(a) of the Lanham Act*

In addition to their claims brought under the current United States copyright laws, artists have employed theories under other provisions of existing law in an effort to create substitute remedies and thereby gain protection for their works similar to that granted in civil law countries. The most successful and

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[79] *Id.* at 439–41. In fact, United Video deleted only one show while leaving the original performance completely intact.

[80] *See, e.g.*, Kwall, *supra* note 14, at 35–37; *see also* Barnett, *supra* note 78, at 442–48 (discussing only the *WGN* decision).

[81] *WGN* has to date never been cited for the proposition that alteration equals copyright infringement. The only case apparently to follow the *Gilliam* court's copyright infringement rationale besides *WGN* was National Bank of Commerce v. Shaklee Corp., 503 F. Supp. 533, 543–44 (W.D. Tex. 1980) (holding that the inclusion of advertisements in the text of a book infringes the copyright if done without the authority of the creator); *see also* Diamond, *Legal Protection for the "Moral Rights" of Authors and Other Creators*, 68 TRADEMARK REP. 244 (1978), where the author observes:

> The marked differences of opinion among commentators, the strong dissent on this point by Judge Gurfein, and the fact that the Second Circuit in earlier cases has disavowed the doctrine of moral right per se, raise serious questions about the amount of influence the Monty Python decision will have on United States law in this field.

*Id.* (footnote omitted); *cf.* Directors Guild of America, Inc. v. Paramount Pictures Corp., Directors/Producers Arbitration Tribunal No. 01738 (1985) (Mosk, Arb.). In *Directors Guild*, Warren Beatty, the director of the movie "Reds," entered into an agreement with Paramount Pictures whereby Paramount would "use [its] best efforts to obtain exhibition of the picture on television . . . without any reduction in length from the [final] version of the picture." *Id.* at 5. After ABC had expressed an interest in exhibiting the movie, Paramount orally agreed with Beatty to re-acquire the television rights from ABC in the event that Beatty was not satisfied with the version of "Reds" that ABC planned to present on television. *Id.* at 7–8. Paramount then sold the television rights to ABC, and granted ABC the right to edit the movie for time-cut purposes (i.e., for commercials or other timing reasons). *Id.* at 8. Beatty sought to prevent ABC from deleting 6 minutes and 25 seconds of the movie. *Id.* The arbitrator concluded that Paramount had conveyed to ABC a right to time-cut that it did not possess. *Id.* at 10–15. Thus, if ABC refused to telecast the movie unabridged, Paramount would be required to repurchase the license it granted to ABC. *Id.* at 5. Interestingly, the arbitrator cited *Gilliam* as "almost on all fours factually," *id.* at 28, even though the plaintiffs in *Gilliam* had not explicitly retained the right to prevent alteration as Beatty had done with his movie "Reds."

notable attempts at protecting artists' moral rights have been those grounded in section 43(a) of the Federal Trademark Act, better known as the Lanham Act.[82]

Unlike the other portions of the Lanham Act, section 43(a) has nothing to do with registered trademarks. It has been observed that "[a]lthough § 43(a) was envisioned as a federal false advertising statute, it has also evolved into something of a federal law of unfair competition."[83] Artists have been successful in convincing courts to protect their rights of paternity and integrity by framing their claims in the language of section 43(a).

*Smith v. Montoro*,[84] for example, involved a claim for what amounted to an artist's right of paternity. In *Montoro*, an actor named Paul Smith who had appeared in the film "Convoy Buddies" charged the film's distributor with removing his name from the credits and substituting the name of another actor, Bob Spencer.[85] The Court of Appeals for the Ninth Circuit reversed the district court's order dismissing the complaint for failure to state a federal claim, and held that the defendant's alleged conduct, if true, constituted "reverse passing off."[86] The reasoning of *Montoro* suggests that if an author's name is eliminated from his or her work, the author has a claim under section 43(a) that roughly parallels the right of paternity aspect of the *droit moral*.

Similarly, in the *Gilliam* case the Second Circuit held that the Monty Python group, in addition to its copyright claim, had successfully asserted a claim under section 43(a) of the Lanham Act. The *Gilliam* court reasoned that a section 43(a) cause of

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[82] Ch. 79-540, § 43(a), 60 Stat. 427, 441 (1946) (codified at 15 U.S.C. § 1125(a) (1982)). Section 43(a) states:

> Any person who shall affix, apply, or annex, or use in connection with any goods or services, or any container or containers for goods, a false designation or origin, or any false description or representation, including words or other symbols tending falsely to describe or represent the same, and shall cause such goods or services to enter into commerce, and any person who shall with knowledge of the falsity of such description or representation cause or procure the same to be transported or used in commerce or deliver the same to any carrier to be transported or used, shall be liable to a civil action by any person doing business in the locality falsely indicated as that of origin or in the region in which said locality is situated, or by any person who believes that he is or is likely to be damaged by the use of any such false description or representation.

*Id.*

[83] R. Brown & R. Denicola, Copyright 445 (2d ed. 1985).

[84] 648 F.2d 602 (9th Cir. 1981).

[85] *Id.* at 603.

[86] *Id.* at 604–07. Reverse passing off, the court explained, "occurs when a person removes or obliterates the original trademark, without authorization, before reselling goods produced by someone else." *Id.* at 605.

action exists regardless of any licensing agreement whenever a television network broadcasts "a program properly designated as having been written and performed by a group but which has been edited, without the writer's consent, into a form that departs substantially from the original work."[87] Since ABC's edited version had "at times omitted the climax of the skits, to which appellants' rare brand of humor was leading and at other times deleted essential elements in the schematic development of story line," the court agreed with the district court that it "impaired the integrity" of the group's work and was "a mere caricature of their talents."[88] The court concluded that to represent the work to the public as that of the group was misleading and thus violated section 43(a).[89]

The *Gilliam* decision was hailed by some commentators as a major victory for the artists' right of integrity,[90] and attacked by others as an overbroad interpretation of section 43(a) of the Lanham Act.[91] In fact, few artists have successfully asserted integrity rights under the *Gilliam* court's reading of section

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[87] Gilliam v. American Broadcasting Cos., 538 F.2d 14, 24 (2d Cir. 1976).

[88] *Id.* at 25. The court gave an example of what it considered to be the distortion committed by ABC:

> In one skit, an upper class English family is engaged in a discussion of the tonal quality of certain words as "woody" or "tinny." The father soon begins to suggest certain words with sexual connotations as either "woody" or "tinny," whereupon the mother fetches a bucket of water and pours it over his head. The skit continues from this point. The ABC edit eliminates this middle sequence so that the father is comfortably dressed at one moment and, in the next moment, is shown in a soaked condition without any explanation for the change in his appearance.

*Id.* at 25 n.12.

[89] Judge Gurfein concurred with the majority, but wrote separately to express his views on the scope of § 43(a). Judge Gurfein noted that the Lanham Act "is not a substitute for *droit moral* which authors in Europe enjoy" and "does not deal with artistic integrity," *id.* at 27, but rather was designed solely as a remedy for misdescription of origin. Under Judge Gurfein's view, the proper remedy for the group's § 43(a) claim was to require ABC to broadcast a disclaimer during the show stating that the group did not approve of the editing. *Id.* The majority rejected this view:

> We are doubtful that a few words could erase the indelible impression that is made by a television broadcast, especially since the viewer has no means of comparing the truncated version with the complete work in order to determine for himself the talents of plaintiffs.

*Id.* at 25 n.13.

[90] *Monty Python Litigation*, *supra* note 11, at 624; Krigsman, *supra* note 13, at 265–68; Kwall, *supra* note 14, at 20–24; Note, *supra* note 32, at 480–81.

[91] Annual Review Committee, *The Thirtieth Year of Administration of the Lanham Trademark Act of 1946*, 67 TRADEMARK REP. 471, 564–68 (1977); Comment, *Monty Python and the Lanham Act: In Search of the Moral Right*, 30 RUTGERS L. REV. 452, 476 (1977).

43(a).[92] As will be discussed more fully below, the necessarily narrow scope of protections afforded by section 43(a), as well as existing limitations on actions under the copyright laws and under the various common law theories that artists have developed, demonstrates the need for federal legislation that would explicitly and comprehensively provide appropriate protections for the rights of artists.

### C. *Common Law Substitutes for Moral Rights Protection in the United States*

It is well established that no general common law equivalent of the *droit moral* or the *droit de suite* exists in this country.[93] However, artists have based claims for relief on what are essentially substitutes for moral rights in various existing areas of the common law.[94] The state common law claims most often relied upon for the equivalent of moral rights fall within the

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[92] No court to date has cited *Gilliam* for the proposition that § 43(a) of the Lanham Act protects an artist's right of integrity. *See* Gantz, *supra* note 32, at 878 n.43.

[93] In Vargas v. Esquire, Inc., 164 F.2d 522 (7th Cir. 1947), for example, the court stated:

> The conception of "moral rights" of authors so fully recognized in the civil law countries has not yet received acceptance in the law of the United States. No such right is referred to by legislation, court decisions or writers.
>
> What plaintiff in reality seeks is a change in the law in this country to conform to that of certain other countries. We need not stop to inquire whether such a change, if desirable, is a matter for the legislative or judicial branch of the government; in any event, we are not disposed to make any new law in this respect.

*Id.* at 526; *see also Gilliam*, 538 F.2d at 24 ("American copyright law, as presently written, does not recognize moral rights or provide a cause of action for their violation"); Miller v. Commissioner, 299 F.2d 706, 709 n.5 (2d Cir. 1962) (same); Granz v. Harris, 198 F.2d 585, 589–91 (2d Cir. 1952) (same) (Frank, J., concurring); 2 S. LADAS, THE INTERNATIONAL PROTECTION OF LITERARY AND ARTISTIC PROPERTY § 367, at 802 (1938); Krigsman, *supra* note 13, at 256–62; Kwall, *supra* note 14, at 18–20; Gantz, *supra* note 32, at 875 & n.2; 2 M. NIMMER, *supra* note 23, § 8.21[B].

[94] *Gilliam*, 538 F.2d at 24 (recognizing that courts have granted artists relief for misrepresentation by relying on common law theories); Geisel v. Poynter Prods., Inc., 295 F. Supp. 331, 340 (S.D.N.Y. 1968) (noting that the moral rights doctrine is not part of the law of this country "except insofar as parts of that doctrine exist in our law as specific rights—such as copyright, libel, privacy and unfair competition"); Edison v. Viva Int'l, Ltd., 70 App. Div. 2d 379, 384, 421 N.Y.S.2d 203, 206 (1979) ("a right analogous to 'moral right' . . . has been recognized in this country . . . so that in at least a number of situations the integrity and reputation of an artistic creator have been protected by judicial pronouncements"); *see also* Krigsman, *supra* note 13, at 256–62; Kwall, *supra* note 14, at 18–20; 2 M. NIMMER, *supra* note 23, § 8.21[B]; *see generally* Roeder, *supra* note 36, at 558–74.

areas of contract,[95] custom and practice,[96] defamation,[97] unfair competition,[98] and right of privacy.[99] Arguably, artists could also seek a form of resale royalty rights based on reformation of contract claims grounded in theories of unjust enrichment or changed circumstances.[100]

Artists' efforts to persuade the courts to look beyond the words of a purchase or licensing agreement generally have not prevailed. Courts traditionally have been reluctant to read into such agreements rights for which there is no specific contractual

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[95] *E.g.*, *Granz*, 198 F.2d at 588 (contractual requirement to credit plaintiff with musical content of records included an implied "duty not to sell records which make the required legend a false representation"); *Edison*, 70 App. Div. 2d at 384, 421 N.Y.S.2d at 206 (complaint by author alleging material alteration of a magazine article by the publisher states a cause of action for breach of contract).

[96] *E.g.*, Crimi v. Rutgers Presbyterian Church, 194 Misc. 570, 572, 89 N.Y.S.2d 813, 816 (Sup. Ct. 1949) ("[t]he gist of this claimed custom is that the work, if accepted as being of high artistic standard, will not be altered, mutilated, obliterated or destroyed").

[97] Prouty v. National Broadcasting Co., 26 F. Supp. 265, 266 (D. Mass. 1939) (plaintiff may recover based on principles of "unfair competition" if she can demonstrate that the unauthorized use of her plots and principal characters injured both her reputation and that of her novel, and constituted a deception of the public); *cf.* Seroff v. Simon & Schuster, Inc., 6 Misc. 2d 383, 162 N.Y.S.2d 770 (Sup. Ct. 1957) (where author gave publisher rights of translation and foreign publication, author could not then recover in an action for libel damages to his reputation resulting from distorted translation of his book).

[98] *E.g.*, *Granz*, 198 F.2d at 588; Vargas v. Esquire, Inc., 164 F.2d 522, 526–27 (7th Cir. 1947); RCA Manufacturing Co. v. Whiteman, 114 F.2d 86, 90 (2d Cir. 1940); *Prouty*, 26 F. Supp. at 266; *see also* Roeder, *supra* note 36, at 567 & n.65.

[99] *See* N.Y. Civ. Rights Law §§ 50, 51 (McKinney 1976) (statutory right of privacy); Ellis v. Hurst, 66 Misc. 235, 121 N.Y.S. 438 (Sup. Ct. 1910) (statutory right of privacy violated when work that had originally been published under a pseudonym was published under author's name without authorization); Eliot v. Jones, 66 Misc. 95, 120 N.Y.S. 989 (Sup. Ct.), *aff'd*, 140 App. Div. 911, 125 N.Y.S. 1119 (1910) (right of privacy violated when name of editor of a series of books was used in advertising for inferior version of that series); Geisel v. Poynter Prods., Inc., 295 F. Supp. 331, 355–57 (S.D.N.Y. 1968) (dismissing right of privacy claim brought by "Dr. Seuss", on the ground that tradename not protected by right of privacy statute); *see also* Diamond, *supra* note 81, at 266 & n.125; Krigsman, *supra* note 13, at 256–61; Kwall, *supra* note 14, at 18–20; 2 M. Nimmer, *supra* note 23, § 8.21[B]; Roeder, *supra* note 36, at 562; *cf.* Williams v. Weisser, 18 Cal. Rptr. 542, 163 U.S.P.Q. (BNA) 42 (Dist. Ct. App. 1969) (finding that a professor had a common law privacy right not to have his class lectures published without his permission). Related to the right of privacy is the right of publicity, which has been described as "the interest of the individual in the exclusive use of his own identity, insofar as it is represented by his name and likeness." Restatement (Second) of Torts § 652(2) (1962); *see also* Krigsman, *supra* note 13, at 261–62; Nimmer, *The Right of Publicity*, 19 Law & Contemp. Probs. 203, 215 (1954); *Toward Artistic Integrity*, *supra* note 32, at 1546–47.

[100] Artists could argue, for example, that because the original agreement between the parties rested on incorrect assumptions about the value of the artwork, the original sale price unjustly enriches the purchaser to the detriment of the artist. *See* Study 31, Subcomm. on Patents, Trademarks, and Copyrights of the Senate Comm. on the Judiciary, 86th Cong., 1st Sess., Copyright Law Revision Studies 29–31 105, 188 (Comm. print 1960) (prepared by B. Ringer) ("when most copyright bargains are made there is no way to judge the ultimate value or life of the work").

provision.[101] Further, the courts' willingness in some areas of the law to reform contracts due to unconscionability[102] or unequal bargaining power has apparently not extended to the area of artists' commercial relations. Thus as a general matter artists possess only those rights that are specifically spelled out in their contracts, with the result that in most cases they have no common law recourse when their work is altered, wrongly attributed, or resold at a substantial premium.

## III. The Inadequacy of Existing Remedies as Substitutes for Congressional Protection of Moral and Resale Rights

As discussed in the previous section, the *Gilliam* and *WGN* cases might appear to represent strong advances in the protec-

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[101] In Edison v. Viva Int'l, Ltd., 70 App. Div. 2d 379, 421 N.Y.S.2d 203 (1979), for example, the court stated, after acknowledging that some analogues to moral rights have been recognized in the common law:

> Where, however, the parties have entered into a contract of publication, plaintiff's so-called "moral right" is controlled by the law of contract. Consequently, plaintiff Edison's moral right has been subsumed in his contractual right to seek redress for the alleged mutilation of his article.

*Id.* at 384, 421 N.Y.S.2d at 206; *see also Seroff*, 6 Misc. 2d at 388, 162 N.Y.S.2d at 775 ("[i]t is the function of the court to determine the respective rights of the parties primarily by the contract that they made"); Krigsman, *supra* note 13, at 256 ("[t]he general rule is that unless there is a contractual obligation to give an author credit, there is no legal duty to do so"); Diamond, *supra* note 81, at 261 ("[w]hen a court construes a contract strictly the author generally fails in his attempt to enforce a moral right claim"). Even when courts are persuaded to look beyond the contract in making a determination of the parties' legal rights, they generally look to the "industry standard", which more often than not disfavors artists. *See, e.g.*, Preminger v. Columbia Pictures Corp., 49 Misc. 2d 363, 371, 267 N.Y.S.2d 594, 603 (Sup. Ct.), *aff'd*, 25 App. Div. 2d 830, 269 N.Y.S.2d 913, *aff'd*, 18 N.Y.2d 659, 219 N.E.2d 431, 273 N.Y.S.2d 80 (1966) (in the absence of a specific contractual provision, editing rights for television broadcast of movie would be governed by prevailing industry custom); *see also* Stevens v. National Broadcasting Co., 270 Cal. App. 2d 886, 891–93, 76 Cal. Rptr. 106, 109–10 (Ct. App. 1969) (holding that evidence of custom and usage in the movie industry supported the trial court's finding that the insertion of commercials in a television showing of a film did not constitute "cutting and editing" within the meaning of a contract reserving cutting and editing rights to the producer/director of the film).

[102] In Williams v. Walker Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965), the court set forth a classic statement of the doctrine of unconscionability:

> Unconscionability has generally been recognized to include an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party. . . . Ordinarily, one who signs an agreement without full knowledge of its terms might be held to assume the risk that he has entered a one-sided bargain. But when a party of little bargaining power, and hence little real choice, signs a commercially unreasonable contract with little or no knowledge of its terms, it is hardly likely that his consent, or even an objective manifestation of his consent, was ever given to all the terms. In such a case the usual rule that the terms of the agreement are not to be questioned should be abandoned and the court should consider whether the terms of the contract are so unfair that enforcement should be withheld.

*Id.* at 449–50.

tion of artists' moral rights in this country. Indeed, it has been suggested that these two decisions, combined with other common law causes of action such as defamation, contract, and invasion of privacy, adequately compensate for the lack of an explicit moral rights provision in the United States copyright law.[103] However, these substitute remedies do not provide artists with adequate protection. The limited scope of the *Gilliam* holding, the willingness of courts to enforce the terms of a contract against the artist, the need to fit moral rights claims within the elements of the alternate causes of action, and the copyright law's preference for the copyright holder rather than the creator all demonstrate the limited value of substitute actions in protecting artists' moral rights. In addition, no substitute action provides the equivalent of the resale royalty right granted artists in civil law countries.

### A. *Inherent Limitations on Existing Protections under Federal Copyright Laws*

Although some artists have been successful in asserting moral rights claims under the federal copyright law, as in the *Gilliam* and *WGN* cases, those decisions are limited in scope and applicable in only narrow circumstances. As a result, whatever moral rights protection may be found in existing copyright laws, those protections are poor substitutes for explicit recognition of artists' rights through a direct amendment to the copyright laws.

The facts of the *Gilliam* case demonstrate that the scope of the court's copyright holding is not a major victory for artists seeking to establish moral rights. A critical factor in the court's copyright and license holding was that the Monty Python group retained the copyright in the underlying script for the television show.[104] If the group had transferred that copyright to the BBC,

[103] Strauss, *The Moral Right of the Author,* 4 AM. J. COMP. L. 506, 538 (1955) ("common law principles, if correctly applied, afford an adequate basis for protection of [moral] rights"); *see generally* Treece, *American Law Analogues of the Author's "Moral Rights"*, 16 AM. J. COMP. L. 487 (1969). Similar arguments have been made in the debates over United States participation in the Berne Convention. *See* Statement of the Motion Picture Ass'n of America at 7, *Hearing on H.R. 1623, supra* note 46; Statement of Kenneth W. Dam, vice president of IBM Corp. at 16, *id.*; *see also supra* note 46 (quoting statements of Senators Mathias and Leahy and Representative Moorehead on their respective bills to implement the Berne Convention).

[104] Gilliam v. American Broadcasting Cos., 538 F.2d 14, 19 (2d Cir. 1976).

the BBC would have had the authority to permit ABC to broadcast the edited version of the show.[105]

In *Crimi v. Rutgers Presbyterian Church*,[106] for example, a church was allowed to paint over a twenty-six by thirty-five foot fresco mural because the artist had assigned the copyright to the church.[107] Although the court observed that "[t]he time for the artist to have reserved any rights was when he and his attorney participated in the drawing of the contract with the church,"[108] it failed to note that in most situations, the artist's inferior bargaining position will preclude him from effectively negotiating for adequately protective terms.[109]

In addition, in most situations similar to that presented in *Gilliam*, it is unlikely that the scriptwriter will retain rights in the copyright. Under section 201(b) of the copyright law,[110] when a work is produced "for hire" the "person for whom the work was prepared is considered the author for purposes of [the act]. . . ."[111] Thus, if ABC had paid Monty Python to write the script for the network, ABC would have gained full copyright control over the script and could have altered the television show without fear of liability for copyright infringement.

Another important factor which limits the *Gilliam* holding is the emphasis that the court placed on the specific terms of the licensing agreement between the Monty Python group and the BBC. Because the agreement explicitly reserved to the group all rights not granted to the BBC,[112] and because it contained no provision granting to the BBC the right to edit the television program,[113] the court held that the BBC could not authorize extensive editing without the group's consent.[114] Thus, as one commentator has noted, "*Gilliam*'s ultimate moral right significance may be that in the face of a silent contract, an artist will not be held to have granted his licensee the right to perform extensive editing."[115]

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[105] *Id.*

[106] 194 Misc. 570, 89 N.Y.S.2d 813 (Sup. Ct. 1949).

[107] Apparently, the church painted over the mural because it objected to "the nakedness of the chest of Christ." *Hearing*, *supra* note 5, at 13 (statement of Alfred Crimi, artist).

[108] *Crimi*, 194 Misc. at 576–77, 89 N.Y.S.2d at 819.

[109] *See supra* notes 32–36 and accompanying text.

[110] 17 U.S.C. § 201(b) (1982).

[111] *Id.*

[112] *Gilliam*, 538 F.2d at 21.

[113] *Id.*

[114] *Id.*

[115] Kwall, *supra* note 14, at 35.

This interpretation of *Gilliam*, though seemingly promising, may not be of much help to creators. First, most courts faced with an agreement that is silent on modification have held against artists except where the work is severely mutilated. In *McGuire v. United Artists Television Productions, Inc.*,[116] for example, the CBS television network sought to broadcast an edited version of a movie written and produced by the plaintiff.[117] The plaintiff sought an injunction on the ground that he was not given the "creative control" to which he felt he was entitled.[118] United Artists, like the BBC in *Gilliam*, owned the rights to the movie but apparently did not have any rights in the script.[119] The court nevertheless refused to enjoin United Artists from editing the show to provide CBS with time for commercials, reasoning that the parties had never agreed to a provision specifically limiting United Artists' right to alter the production.[120]

Thus, the principal difficulty with the *Gilliam* holding as a means of protecting artists' moral rights is that it is based in large part on the specific contractual terms at issue in that case. The *Gilliam* court did not have occasion to take into account the well-recognized inequality in bargaining power as between artists and the licensees or purchasers with whom they contract.[121] Even if courts were to interpret silence in a licensing agreement as a limitation on the copyright user's right to alter a work,[122] licensees are frequently able to secure from artists contractual provisions explicitly granting the right to alter or edit. Such provisions are likely to be upheld, since courts consistently enforce against artists specific contractual terms that limit the artists' rights in their work.[123] Thus, it is naive to

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[116] 254 F. Supp. 270 (S.D. Cal. 1966).

[117] *Id.* at 271.

[118] *Id.*

[119] *Id.*

[120] *Id.* Similarly, in Preminger v. Columbia Pictures Corp., 49 Misc. 2d 363, 267 N.Y.S.2d 594 (Sup. Ct.), *aff'd*, 25 App. Div. 2d 830, 269 N.Y.S.2d 913, *aff'd*, 18 N.Y.2d 659, 219 N.E.2d 431, 273 N.Y.S.2d 80 (1966), the court held in the face of a silent agreement that editorial deletions were contemplated by the parties, since the plaintiff "was aware that the practice of the television industry was to interrupt motion pictures for commercials and to make minor cuts." *Id.* at 369, 267 N.Y.S.2d at 601.

[121] *See supra* notes 32–36 and accompanying text.

[122] One commentator has argued that since a rights reservation clause such as that at issue in *Gilliam* would only apply to the script, contractual silence as to the final television show would permit networks to edit the show without consent. *Monty Python Litigation*, *supra* note 11, at 630.

[123] *See, e.g.*, Seroff v. Simon & Schuster, Inc., 6 Misc. 2d 383, 162 N.Y.S.2d 770 (Sup. Ct. 1957). Under contract law, the only basis for refusing to enforce such a waiver

suggest that strict enforcement of licensing and sales contracts clauses will help establish protection for moral rights. While the *Gilliam* copyright rationale might help those artists who are fortunate enough to secure an agreement that is silent on alteration, that rationale will work against artists who are forced to sign contracts permitting extensive editing.

Similarly, the *Gilliam* court's reasoning as to contractual silence will not avail artists who either sell the copyright in their work outright or produce the work for hire. In neither of those situations will the artists retain any interest that can be protected by the copyright laws.

Finally, the copyright laws have never been interpreted to provide artists with the equivalent of a *droit de suite*, or resale right. Copyright laws are not currently designed to protect the economic interests of the artist.[124] Under existing law, if an artist does not retain the copyright in a given work of art, that artist stands to gain no financial rewards from subsequent increases in the value of the work.[125]

### B. *The Unsuitability of the Lanham Act as a Substitute for Explicit Copyright Protection for Artists*

The *Gilliam* court's holding on the Monty Python group's Lanham Act claim provides one advantage to artists over the court's copyright rationale, in that section 43(a) of the Lanham Act, unlike the copyright laws, applies to artists who no longer own the copyright in their work. Nonetheless, the *Gilliam* court's interpretation of section 43(a) of the Lanham Act provides an awkward substitute for explicit protection of artists' moral rights. While the court's discussion of section 43(a) adopts the language of moral rights,[126] the court explicitly acknowledged that moral rights are not recognized by the copyright laws

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would be a showing by the artist of duress, fraud, or the like. *See generally* RESTATEMENT (SECOND) OF CONTRACTS §§ 159–177, 208 (1981).

[124] Roeder, *supra* note 36, at 576; *see also Hearing*, *supra* note 5, at 25 (statement of Gustave Harrow).

[125] 2 M. NIMMER, *supra* note 23, § 8.22[A].

[126] The court spoke in terms of the Monty Python group's right of integrity in its work and the group's right to prevent manipulation of the work. Gilliam v. American Broadcasting Cos., 538 F.2d 14, 24–25 (2d Cir. 1976) (prior decisions granting relief for "'misrepresentation of an artist's work' properly vindicate the author's personal right to prevent the presentation of his work to the public in a distorted form" (citations omitted)).

of this country, and that the Lanham Act was not designed as a moral rights law.[127] Indeed, one writer has noted that the "[c]ommentary and legislative history indicate that the Act was . . . largely designed to combat problems associated with false advertising in the sale of goods or services related to trademarks."[128]

Even if section 43(a) were interpreted to apply in situations where an artist's reputation is damaged due to an altered work, the provision is a poor substitute for the moral right of integrity protected in civil law countries. First, there is disagreement over whether a simple disclaimer can cure a section 43(a) violation.[129] Moreover, it is conceivable that ABC in the *Gilliam* case could have avoided a section 43(a) claim by simply broadcasting the special without attributing the show to the Monty Python group.[130]

Another major problem with relying on section 43(a) for moral rights protection is that it cannot be invoked if the author or artist has contracted away the right to edit.[131] Thus, an artist's moral rights claim under section 43(a) is only as strong as the contract. Since the *Gilliam* court's copyright infringement analysis depended on the licensing agreement, the entire *Gilliam* case appears to have turned on the silence in that agreement.

Other issues complicate any attempt to protect moral rights through a section 43(a) cause of action. For a section 43(a) claim

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[127] *Id.* at 24.

[128] Note, *supra* note 32, at 481; *see also* Derenberg, *Federal Unfair Competition at the End of the First Decade of the Lanham Act: Prologue or Epilogue?*, 32 N.Y.U. L. REV. 1029, 1039 (1957) ("the primary and most important purpose of section 43(a) was to provide a private remedy in cases of false advertising"). In a recent decision, Halicki v. United Artists Communications, Inc., 812 F.2d 1213 (9th Cir. 1987), the Court of Appeals for the Ninth Circuit declined to extend its holding in Smith v. Montoro, 648 F.2d 602 (9th Cir. 1981), or the Second Circuit's holding in *Gilliam*, 538 F.2d 14, to a case where the defendants had advertised a film as rated "R" when in fact it was rated "PG." *Halicki*, 812 F.2d at 1214. The court rejected the notion that § 43(a) was intended to be a federal misrepresentation statute. *Id.* Rather, the court held that § 43(a) was directed at unfair competition, and thus in order to prevail the plaintiff producer would have to make a showing of competitive injury. *Id.* The *Halicki* decision can be seen as limiting *Gilliam* and *Montoro* to "their particular factual setting[s]." *Id.*

[129] *E.g.*, Annual Review Committee, *supra* note 91, at 566–67:

> The basic difference between the majority and minority involved the perennial question of whether a disclaimer could cure an admitted misrepresentation as to origin. The majority was probably correct, in our view, that no disclaimer can really dissociate the reputation of MONTY PYTHON from the stigma of the mutilated program.

*Id.* (capitalization in original).

[130] Krigsman, *supra* note 13, at 268.

[131] *Gilliam*, 538 F.2d at 27 (Gurfein, J., concurring); Annual Review Committee, *supra* note 91, at 567–68.

to prevail, there must be a distortion of the underlying work.[132] De minimis alteration of the work is not sufficient.[133] In *Gilliam* the court found that cutting twenty-seven percent of the Monty Python show distorted the group's message. Yet there is no clear standard as to how much editing is too much.[134] Moreover, a purchaser arguably cannot be held liable under section 43(a) if the purchaser's actions so distort a work that it is not recognizable as that of the artist, since under those circumstances no claim for misrepresentation or damage to the artist's reputation would arise.

Finally, as with the right of integrity, the Lanham Act's protection of the right of paternity is limited. Although the court in the *Montoro* case discussed above[135] upheld the author's right to have his name attached to his work,[136] that holding may be limited to a situation where the author's name is replaced with that of somebody else. The court did not address the question whether section 43(a) is violated if the author's name is simply removed and not replaced. Arguably, no misrepresentation or passing off occurs unless the work has a strong secondary meaning so that the audience connects the work to the artist. Thus, as with the right of integrity, the only way for artists to guarantee protection for their right of paternity is to secure explicit contractual provisions granting them such a right.[137]

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[132] Krigsman, *supra* note 13, at 268.

[133] *Id.*; *cf.* Preminger v. Columbia Pictures Corp., 49 Misc. 2d 363, 267 N.Y.S.2d 594 (Sup. Ct.), *aff'd*, 25 App. Div. 2d 830, 269 N.Y.S.2d 913, *aff'd*, 18 N.Y.2d 659, 219 N.E.2d 431, 273 N.Y.S.2d 80 (1966).

[134] In *Preminger*, for example, the producer of a film sought an injunction to prevent cuts that were made to accommodate commercial breaks. The contract with the network contained no specific provision withholding the right to edit. 49 Misc. 2d at 366, 267 N.Y.S.2d at 598. The court held that the defendant Columbia Pictures had the right to edit the film to the degree normally employed in the industry. *Id.* at 371, 267 N.Y.S.2d at 603.

[135] Smith v. Montoro, 648 F.2d 602 (9th Cir. 1981); *see supra* notes 84–86 and accompanying text.

[136] *Cf.* Follett v. Arbor House, 497 F. Supp. 304 (S.D.N.Y. 1980). In *Follett*, the plaintiff had edited the English translation of a French mystery and successfully sought to prevent the defendant from attributing authorship of the work to him.

[137] The case law suggests that where an author's name is simply removed from a work rather than replaced with another name, the author's rights are governed by contract. *E.g.*, Wolfe v. United Artists, 583 F. Supp. 52 (E.D. Pa. 1983); Seroff v. Simon & Schuster, Inc., 6 Misc. 2d 383, 387–88, 162 N.Y.S.2d 770, 775 (Sup. Ct. 1957). In *Wolfe*, a case brought under the copyright laws, the court rejected a claim that the publisher's removal of the author's name from a book was unlawful. The court reasoned that "whether or not defendants breached any such obligations . . . can only be made by reference to these agreements. . . ." *Wolfe*, 583 F. Supp. at 56.

### C. *Practical Limitations on State Common Law Remedies*

The difficulties associated with reliance on Lanham Act and copyright theories to protect the moral rights of integrity and paternity also arise when artists assert state common law claims to protect those rights. For example, to succeed in a defamation suit, an artist must prove that a given alteration subjected the artist to public ridicule and injured the artist's professional standing. Thus, it is possible that, as under section 43(a), no cause of action would arise if the purchaser mutilates or destroys the work without presenting it to the public. More importantly, a state law contract claim is usually unavailable, since in most cases the artist lacks the bargaining power to secure an explicit contractual provision that prohibits alteration of the work.[138] As discussed above, courts have not taken this inequality of bargaining power into account in interpreting artists' contracts.[139]

### D. *The Shortcomings of Substitutes for Explicit Federal Protection of Moral Rights*

All that American creators currently possess to protect their rights in their work is a patchwork of federal and state actions that do not nearly approximate the cohesive protections that would be afforded by an explicit amendment to the copyright laws providing artists with moral rights protection.[140] The principal problem with these substitute actions is that in order to prevail, artists must conform their moral rights claims to fit the elements of a specific substitute action. And since most of the alternative remedies are designed to protect economic rather than personal interests, many of the elements that need to be proven are significantly different from those in moral rights cases.[141] Even if an artist can fit a moral rights claim within the elements of the substitute claim, it is unclear in a given instance what protection will be provided. For example, one court may interpret contractual silence as a reservation to the artist of the right to alter a work, while another may view such silence as providing the purchaser or licensee with an implied right of

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[138] *See supra* notes 32–36 and accompanying text.
[139] *See supra* notes 101–02 and accompanying text.
[140] *See* Amarnick, *supra* note 44, at 60–71; DaSilva, *supra* note 9, at 39; Krigsman, *supra* note 13, at 256–62.
[141] *See* Kwall, *supra* note 14, at 23–24.

alteration. Moreover, since virtually all of the existing substitute rights can be contracted away, even those protections to which the artist would otherwise be entitled will more often than not succumb to the artist's inferior bargaining position.[142]

Reliance on existing federal and state remedies as substitutes for the rights of integrity and paternity raises an additional problem—the lack of protection for other rights associated with the *droit moral*. The right of withdrawal, it has been observed, receives little protection under section 43(a) of the Lanham Act, federal copyright law, or state common law.[143]

In fact, in some instances the copyright law may itself preclude non-copyright actions for protection of the right of withdrawal. For example, under the common law "first-sale rule," now codified in section 109(a) of the copyright law,[144] the holder of a copyright can control only the first sale of the work. The buyer then has the right, without the consent of the copyright owner, "to sell or otherwise dispose of the possession of that copy."[145] Thus, even if the creator retains the copyright in a work, he can claim no right of withdrawal under either a copyright or common law cause of action since the buyer controls the right to resell the work. In addition, the buyer's right under section 109(a) "to dispose" of a copy would allow the buyer to destroy the work.[146] The only possible copyright action to prevent such destruction would be under section 106(2),[147] which grants the exclusive right to prepare a derivative work to the copyright holder. That claim would likely prove unsuccessful, however, since a work that is altered beyond recognition and not attributed to the artist might be viewed as a new work that is not a derivative work under section 106(2). Also, as discussed earlier, no Lanham Act section 43(a) claim would be available to stop the destruction.

The public display aspect of the right of withdrawal is similarly limited by the copyright law. Under section 109(c), the owner of a copy may display the work publicly without the

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[142] *See supra* notes 32–36 and accompanying text.

[143] Krigsman, *supra* note 13, at 270–72.

[144] 17 U.S.C. § 109(a) (1982).

[145] *Id.*

[146] The legislative history, it has been observed, suggests that the copyright owner cannot prevent the owner of a lawful copy from destroying that copy. *See* Kwall, *supra* note 14, at 62.

[147] 17 U.S.C. § 106(2) (1982).

approval of the copyright holder.[148] Thus even if the creator of a work retains the copyright in the work, no protection is granted for the artist's right of withdrawal. As long as there is no distortion or alteration of a work, the effect of section 109(c) is to leave the creator without any recourse if the owner of a copy displays the work in a surrounding that the creator finds offensive.

In *Shostakovich v. Twentieth Century-Fox Film Corp.*,[149] the court was faced with an analogous situation. In *Shostakovich*, several Russian composers alleged that the use of their music in a movie with an anti-Soviet theme was offensive. The composers won the moral rights case they filed in France.[150] They proved unsuccessful, however, in their parallel American suit. Since the music was in the public domain, no copyright claim was available. Even if the music had been protected by the copyright law, section 109(c) of the copyright laws would have allowed the defendant's use of the music.[151] Moreover, since no misdescription of origin was alleged, a Lanham Act claim was unavailable.[152]

### E. *The Lack of* Droit de Suite *Among Available Substitute Remedies*

The most glaring gap in the substitute remedies currently available to artists in this country is the lack of any provision for a resale royalty right—the *droit de suite* granted to artists in civil law countries. With one statutory exception that will be discussed in detail in the next Part,[153] none of the copyright or substitute remedies now in existence in this country provide the artist with the right to participate in future increases in the value of the artwork. The copyright laws make no mention of artists'

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[148] 17 U.S.C. § 109(c) (Supp. 1986).

[149] 196 Misc. 67, 80 N.Y.S.2d 575 (Sup. Ct. 1948), *aff'd*, 275 App. Div. 692, 87 N.Y.S.2d 430 (1949).

[150] *See* Judgment of Jan. 13, 1953, D. Jur. 16, 80 (Cour d'appel Paris); *see also* Kwall, *supra* note 14, at 28 n.103.

[151] Section 109(c) permits the owner of a copy "to display that copy publicly" even if it is offensive to the artist. 17 U.S.C. § 109(c) (Supp. 1986). While the use of music in a movie is not considered a "display" of the music, *see* 17 U.S.C. § 101, the provision would probably apply to painters protesting the appearance of their artwork in a movie.

[152] *Shostakovich*, 196 Misc. at 70, 80 N.Y.S.2d at 578–79.

[153] *See infra* notes 185–96 and accompanying text.

resale rights, and no court has ever attempted to frame such a right absent statutory authority.

The failure to address the *droit de suite* in this country, along with the inadequacy of the patchwork substitute theories that the courts have employed to protect artists, demonstrate the need for explicit legislative approval of artists' moral rights in this country. As one commentator has observed, "The application of so many different doctrines to a subject matter which is so intrinsically homogeneous produces confusion; choice of theory depends on a fortuitous combination of factors, rather than on the basic needs of the problem."[154]

### F. *Additional Legal Difficulties Arising from Lack of Uniformity Among Substitute Theories*

The lack of uniformity among the substitute theories advanced by artists and in some cases adopted by courts may present additional legal difficulties. It could be argued, for example, that ad hoc attempts by the courts to protect artists' moral rights by conforming them to fit within alternate legal theories usurps the constitutional power of Congress to decide the issue.[155] Under this view, since the Constitution grants Congress the power to protect artist's creations, it should be for Congress to determine whether to expand the copyright laws and include a moral rights provision.[156] Indeed, the importance of a uniform national policy on copyright law has been consistently recognized by the Supreme Court.[157] The current situation, whereby some courts protect artists' rights of integrity (as in *Gilliam*) and others refuse to do so (as in *Preminger*), results in a complete lack of uniformity.[158]

The failure of substitute causes of action adequately to protect artists' moral rights, combined with the constitutional grant of

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[154] Roeder, *supra* note 36, at 575.

[155] An analogous argument, along the lines of preemption, has been made with respect to state moral rights and resale royalty statutes. *See infra* notes 234–64 and accompanying text.

[156] *Cf.* 2 M. NIMMER, *supra* note 23, § 8.22[B] (arguing that the California resale royalties statute is preempted by federal copyright law).

[157] *E.g.*, Goldstein v. California, 412 U.S. 546, 555–56 (1973); Sears, Roebuck & Co. v. Stiffel Co., 376 U.S. 225, 231 n.7 (1964).

[158] Many commentators have argued, and legislative history suggests, that a principal reason for the failure of the United States to join the Berne Convention is the protection granted in the agreement for artists' moral rights. *See supra* notes 44–46 and accompanying text.

copyright power to Congress and the need for uniformity and reliability in our copyright law suggest that any attempt to protect the *droit moral* should be made by Congress. Senator Kennedy's legislation provides the opportunity to amend the copyright law to include explicit protection for artists' moral and economic rights.

## IV. THE STATES RESPOND

Three states have declined to wait for Congressional action and have instead passed their own statutes providing limited protections for artists. California, in 1979, was the first state to enact such legislation,[159] followed by New York in 1983,[160] and Massachusetts in 1985.[161] The California legislature also passed, in 1976, the nation's only resale royalty legislation.[162] As will be discussed below, each of the state laws fails to protect all of the rights traditionally considered to be part of the *droit moral*. The state laws differ in their purpose, scope of protection, and coverage granted to protected works.

### A. *Overview of the State Laws*

#### 1. California

a. *Preservation Act*. The California Art Preservation Act (the "Preservation Act") provides limited protection for only two of the rights traditionally included within the *droit moral*—the right of integrity and the right of paternity.[163] An action seeking enforcement of the artist's right of integrity under the ordinance will be successful only if the mutilation, alteration, or destruction was intentional.[164] If the work was being framed, conserved, or restored, then the act complained of must be grossly negligent.[165] As for the paternity right, the Preservation Act grants the creator the absolute right to demand recognition for a

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[159] CAL. CIV. CODE § 987 (West Supp. 1987).
[160] N.Y. ARTS & CULT. AFF. LAW §§ 14.51–.59 (McKinney 1984), *amended by* N.Y. ARTS & CULT. AFF. LAW §§ 11.01, 14.01–.03 (McKinney Supp. 1987).
[161] MASS. GEN. LAWS ANN. ch. 231, § 85S (West Supp. 1986).
[162] CAL. CIV. CODE § 986 (West Supp. 1987).
[163] *Id.*
[164] *Id.* § 987(c)(1).
[165] *Id.* § 987(c)(2).

work.[166] If an artist wishes to disclaim authorship of a work, however, there must be a "just and valid reason"[167] for the disclaimer.

In approving the Preservation Act, the California legislature concluded that "physical alteration or destruction of fine art . . . is detrimental to the artists reputation"[168] and that a work of art "is an expression of the artist's personality."[169] The legislature also determined that the "public interest [is served by] preserving the integrity of cultural and artistic creations."[170]

While the California legislature expressed concern for artistic integrity, it limited the works covered by the legislation. The rights granted in the Preservation Act apply only to works of "fine art," defined in the law as "an original painting, sculpture, or drawing, or an original work of art in glass, of recognized quality, but [not including] work prepared under contract for commercial use by its purchaser."[171] This definition imposes three severe limits on the law's applicability.

First, only paintings, sculptures, drawings, and works in glass are protected by the Preservation Act. Thus, scripts, movies, and reproductions of original paintings are not protected from alteration.[172] Second, the work, even if it falls within one of the four protected categories, must be of "recognized quality."[173] The determination of "recognized quality" is left to the trier of fact[174] and is to be based upon "opinions of artists, art dealers, collectors of fine art, curators of museums, and other persons involved with the creation or marketing of fine art."[175] The Preservation Act's requirement of "recognized quality" brings a dangerous new element into the area of artistic protection. Both the copyright law and state common law have long recognized that it is dangerous to condition protection for creative works on value judgments by judges or juries.[176] Any such condition may result in the exclusion of works outside the main-

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[166] *Id.* § 987(d).
[167] *Id.*
[168] *Id.* § 987(a).
[169] *Id.*
[170] *Id.*
[171] *Id.* § 987(b)(2).
[172] *Id.*
[173] *Id.*
[174] *Id.* § 987(f).
[175] *Id.*
[176] *See, e.g.*, Bleistein v. Donaldson Lithographing Co., 188 U.S. 239, 251–52 (1903); 1 M. NIMMER, NIMMER ON COPYRIGHT, § 2.08[B] (1976).

stream of the art world simply due to their novelty. For example, would Warhol's "Campbell's Soup Can" have been considered a work of "recognized quality" when it was created? As Justice Holmes recognized, if judges were allowed to decide the value of a painting, "some works of genius would be sure to miss appreciation. Their very novelty would make them repulsive. . . . It may be more than doubted, for instance, whether the etchings of Goya or the paintings of Manet would have been sure of protection when seen for the first time."[177] Thus, paintings by established artists would be more likely to receive protection than works by relatively new artists.

The most crucial reason for not allowing judges or juries to make quality determinations, however, is the underlying possibility of censorship. An artist who produces morally or visually offensive works or who attacks the local art community might be denied protection under the Preservation Act simply because of the artist's views or the controversial nature of his work.

Another limitation in the Preservation Act is its exclusion from protection of works produced for hire for "commercial uses."[178] "Commercial use" is defined as a work used "in advertising, magazines, newspapers, or other print and electronic media."[179] Not all works "for hire" are included in this limiting provision, and it would seem that few paintings, sculptures, drawings, or artworks in glass would be subject to the "commercial use" limitation.

Perhaps the most serious limitation on the Preservation Act's protection of artists is its provision allowing artists to waive any and all of their rights "in [a] writing expressly so providing which is signed by the artist."[180] Even if a work of art fits within one of the Preservation Act's four categories of protected works, is of "recognized quality," and is not a work for hire for commercial use, artists are not protected if they have contracted away their rights. The Preservation Act's provision is particularly troubling for artists who have not established a reputation, since they are more likely to be forced to waive their rights in order to sell their works. Since one of the main reasons for enacting moral rights legislation is that most artists lack bargaining

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[177] *Bleistein*, 188 U.S. at 251–52.
[178] CAL. CIV. CODE § 987(b)(2) (West Supp. 1987).
[179] *Id.* § 987(a)(7).
[180] *Id.* § 987(g)(3).

power,[181] it is ironic that the Preservation Act allows these rights to be waived. The Preservation Act also provides for automatic waiver of any rights "if a work of fine art cannot be removed from a building without substantial physical defacement, mutilation, alteration, or destruction. . . ."[182] Thus, no mural painted directly onto a building or sculpture embedded in the architecture, including gargoyles, frescoes, and friezes, can be protected.

The California law does contain two sections that are extremely helpful to artists and that work to ensure that the statute can be enforced. The first declares that a work is protected, as under the copyright law, for the life of the artist and for fifty years thereafter.[183] The second is the statute of limitations which requires a suit to be brought within one year of discovery of the violation or within three years of the unlawful action, whichever is longer.[184] This latter provision assures that artists do not lose their rights if they do not discover the damage until well after the alteration has taken place.

b. *Resale Act.* Three years prior to passing the Art Preservation Act, the California legislature approved the California Resale Royalties Act ("Resale Act"),[185] which enacted a limited *droit de suite* for the state's artists. The Resale Act is particularly significant since no other state, including New York and Massachusetts, has incorporated a resale right into state law.

The Resale Act provides that the artist has an unwaivable right to five percent of the amount obtained from the sale of any work covered by the Act.[186] The statute does not apply to the initial sale of the work by the artist or to a resale at an amount less than the purchase price paid by the seller.[187] An artist or the artist's heirs are entitled to resale payments from the artwork during the life of the artist and for twenty years thereafter.[188]

The Resale Act, like the Preservation Act, applies only to works of "fine art."[189] Although the four categories of artwork

[181] *See supra* notes 32–36 and accompanying text.
[182] CAL. CIV. CODE § 987(h)(1) (West Supp. 1987).
[183] *Id.* § 987(g)(1).
[184] *Id.* § 987(i).
[185] *Id.* § 986.
[186] *Id.* § 986(a).
[187] *Id.* § 986(b).
[188] *Id.* § 986(a)(7).
[189] *Id.* § 986(a), (c)(2).

included within the meaning of "fine art"[190] are identical to those in the Preservation Act, there is no test of "recognized quality" in the Resale Act. The Resale Act applies to works of "fine art" whenever "the seller resides in California or the sale takes place in California,"[191] and the amount of the sale is at least $1,000.[192]

Interestingly, under the Resale Act an artist's resale right is unwaivable.[193] Under the law, the only modification allowed is an increase in the royalty greater than the five percent provided by statute.[194] This sharply contrasts with the Preservation Act, which allows the artist to waive all rights granted by the law.[195] Since the Preservation Act and the Resale Act were passed only three years apart, and since artists' groups have been equally unsuccessful in their attempts to get purchasers to agree to the inclusion of a boilerplate royalty rights clause in contracts, the disparity in the waiver provisions seems irreconcilable. If an artist has insufficient bargaining power to obtain resale rights in a contract, it is hard to imagine how the artist has any greater power to obtain a moral rights clause. Arguably, the need to prohibit a waiver seems stronger under the Preservation Act, since one of its purposes is to protect the public's interest in its artistic culture. Allowing artists to waive their rights under the Preservation Act not only harms the artists, but also seriously affects the public's right to preserve artistic creations.[196]

### 2. New York

The New York Artists' Authorship Rights Act (the "Authorship Act")[197] was enacted in 1983 and amended in 1984 by the state legislature. The aim of the Authorship Act is to protect

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[190] *Id.* § 986(c)(2).
[191] *Id.* § 986(a).
[192] *Id.* § 986(b)(2).
[193] *Id.* § 986(a).
[194] *Id.*
[195] *Id.* § 987(g)(1).
[196] *Cf.* Penn Central Transp. Co. v. City of New York, 438 U.S. 104 (1978) (upholding the City of New York's landmark preservation law). This problem arises when the artist cannot afford to bring suit to protect the artwork, is indifferent toward any alteration of the work, or lacks the bargaining power to prevent a contractual waiver. *See* Gantz, *supra* note 32, at 888–89; Note, *supra* note 39, at 1226–27. *But cf.* Roeder, *supra* note 36, at 570 (if an author is presented with the proposed alteration and approves the change a strong argument can be made that the change should be allowed, "for who can judge better than the creator what constitutes the true and ultimate form of the work?").
[197] N.Y. ARTS & CULT. AFF. LAW § 11.01 (McKinney Supp. 1987).

artists' reputations and to recognize New York's role as "the home of many artists of international repute."[198] Because of the statute's focus on the artist's reputation, its sponsors viewed it as guaranteeing only the artist's right of paternity.[199]

As with the California Preservation Act, New York's Authorship Act applies only to certain works of art. To be covered by the Authorship Act, a work must be classified as "fine art."[200] "Fine art" is limited to "a painting, sculpture, drawing, or work of graphic act, and print, but not multiples."[201] The law does not cover works of "sequential imagery such as that in motion pictures."[202] The most important difference from the Preservation Act is that no showing of "recognized quality" is required for protection under the New York Authorship Act.

The Authorship Act, unlike the Preservation Act, covers reproductions. The statute protects reproductions of works of "fine art" and "photographic print or sculpture of limited edition multiple[s] of not more than three hundred copies."[203]

The New York legislature's principal purpose in enacting the Authorship Act was to protect the artist's reputation. The narrowness of that purpose is demonstrated by the limitations on the law's applicability. Even if a work fits within one of the defined categories of the Authorship Act, no protection is available unless the work is "knowingly displayed in a place accessible to the public, published or reproduced in this state."[204] Similarly, the law's protection against alteration or mutilation only applies when "damage to the artist's reputation is reasonably likely to result. . . ."[205] In addition, if an altered or mutilated work is not identified as the artist's, then a cause of action

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[198] New York Artists' Authorship Rights Act, ch. 994, § 1, 1983 N.Y. Laws (statement of purpose).

[199] Note, *The New York Artists' Authorship Act: Increased Protection and Enhanced Status for Visual Artists*, 70 CORNELL L. REV. 158, 170–71 (citing Letter from Richard N. Gottfried, Assistant Majority Leader of the New York Assembly, to Governor Mario Cuomo (July 5, 1983), and Letter from Matthew J. Murphy, Chairman of the New York Assembly Committee on Tourism, the Arts, and Sports Development, to Governor Mario Cuomo (July 22, 1983)). Mr. Gottfried had hoped "to give an artist the right to prevent destruction or alteration of his or her artwork in the hands of subsequent owners. It became clear that the practical, legal and constitutional obstacles to such legislation were large and complex." Letter from Richard N. Gottfried to Alice Daniel (July 5, 1983), *quoted in* Scott & Cohen, *supra* note 32, at 372 n.18.

[200] N.Y. ARTS & CULT. AFF. LAW § 14.03(3)(e).

[201] *Id.* § 11.01(9).

[202] *Id.* § 14.03(1).

[203] *Id.*

[204] *Id.* § 14.03(3)(e).

[205] *Id.* § 14.03(1).

results only if "it would reasonably be regarded as being the work of the artist, and damage to the artist's reputation is reasonably likely to result therefrom."[206] Thus, alteration alone is not actionable; rather, the only harmful act is a public display of an altered work, which is likely to bring disrepute upon the artist.

The Authorship Act's focus on public display sharply contrasts with the Preservation Act, which contains no display requirement. The reason for this difference is that one of the purposes of the Preservation Act—to preserve the state's culture[207]—is not addressed by the Authorship Act. In New York, only an aggrieved artist may bring an action under the Authorship Act and no provision exists for extending the rights beyond the life of the artist.

The New York Authorship Act does provide a limited right to disclaim authorship of a work.[208] Like the California Preservation Act, the Authorship Act limits the right to disclaim authorship to situations where the artist has a "just and valid reason."[209] Unlike the Preservation Act, however, the Authorship Act defines "just and valid" to include situations in which "the work has been altered, defaced, mutilated or modified other than by the artist, without the artist's consent, and damage to the artist's reputation is reasonably likely to result or has resulted therefrom."[210]

Interestingly, the Authorship Act does not address the question whether artists can waive their statutory rights. While the Authorship Act excludes works "prepared under contract for advertising or trade use,"[211] it allows the artist to include in the contract a provision invoking the law's applicability in these commercial situations.[212] Of the five subsections which limit the applicability of the Authorship Act,[213] this subsection is the only one allowing the parties to agree contractually to the Authorship Act's coverage despite a limiting provision. There is no mention as to whether contract clauses may be used to waive other protections provided by the Authorship Act. One commentator

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[206] *Id.*
[207] CAL. CIV. CODE § 987(a) (West Supp. 1987).
[208] N.Y. ARTS & CULT. AFF. LAW § 14.03(2)(a) (McKinney Supp. 1987).
[209] *Id.*
[210] *Id.*
[211] *Id.* § 14.03(3)(d).
[212] *Id.*
[213] *Id.* § 14.03(3)(a)–(e).

suggests that the provision in the statute allowing alteration of a work with the artist's consent indicates that a contractual waiver is permissible.[214] Yet, "consent" as used by the legislature may mean simply that an owner is protected from suit if the artist gave permission once fully informed of the proposed alteration. The legislature may not have intended its consent clause to be broadly construed to allow such a general waiver. If it had, it would have likely added to the list of limitations a sixth subsection so defining consent.

Finally, the statute of limitations in the Authorship Act is identical to that in the Preservation Act. A suit must be brought under the Authorship Act within three years of the violation or within one year of the plaintiff's discovery of it.[215]

### 3. Massachusetts

The Massachusetts statute[216] is strikingly similar to the California Preservation Act,[217] although there are important differences. Both statutes cover only "fine art" of "recognized quality";[218] cover only the artist's rights of integrity and paternity;[219] protect artworks for fifty years following an artist's death;[220] and provide explicitly for contractual waiver of the artist's rights.[221]

Perhaps the most important difference between the Preservation Act and the Massachusetts statute is their respective definitions of "fine art." The Massachusetts statute, unlike both the California Preservation Act and the New York Authorship Act, defines "fine art" in broad terms[222] and does not set out any definitive list of protected artworks. Included as "fine art" is "any original work of visual or graphic art of any media which shall include, *but not limited* [*sic*] *to*, any painting, print, draw-

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[214] Scott & Cohen, *supra* note 32, at 380–81. *But see* Damich, *supra* note 32, at 1744–45.

[215] N.Y. ARTS & CULT. AFF. LAW § 14.03(4)(b) (McKinney Supp. 1987).

[216] MASS. GEN. LAWS ANN. ch. 231, § 85S (West Supp. 1986).

[217] The legislative findings of the Massachusetts General Court are identical to those of the California legislature. MASS. GEN. LAWS ANN. ch. 231, § 85S(a) (West Supp. 1986).

[218] CAL. CIV. CODE § 987(b)(2) (West Supp. 1987); MASS. GEN. LAWS ANN. ch. 231, § 85S (West Supp. 1986).

[219] CAL. CIV. CODE § 987(c)–(d) (West Supp. 1987); MASS. GEN. LAWS ANN. ch. 231, § 85S(c)–(d) (West Supp. 1986).

[220] CAL. CIV. CODE § 987(g)(1) (West Supp. 1987); MASS. GEN. LAWS ANN. ch. 231, § 85S(g) (West Supp. 1986).

[221] CAL. CIV. CODE § 987(g)(3) (West Supp. 1987); MASS. GEN. LAWS ANN. ch. 231, § 85S(g) (West Supp. 1986).

[222] MASS. GEN. LAWS ANN. ch. 231, § 85S(b) (West Supp. 1986).

ing, sculpture, craft object, photograph, audio or video tape, film, hologram, or any combination thereof. . . ."[223] Thus, movies and television productions are included within the definition of "fine art."[224]

Although the definition of "fine art" in the Massachusetts statute speaks of "original work," it does not explicitly state whether it covers reproductions and multiple copies. The issue for the state courts is whether the term "original work" means an artwork that is both unique and one-of-a-kind or simply one that "owes its origin to the author."[225] If multiple copy works are covered under the law, then the inclusion of film and videotape in the definition of "fine art" has some meaning since virtually all such works are reproduced. Significantly, under this interpretation, the "colorization" of black and white films might be actionable in Massachusetts even if it did not affect the original black and white version of the movie.[226]

There are four additional differences between the Massachusetts statute and the California Preservation Act. First, alteration or mutilation is actionable in Massachusetts if it results from either gross negligence or intentional harm.[227] In California, such actions must be intentional.[228] Second, all works created by the artist as an employee and in the course of employment are excluded from protection by the Massachusetts statute.[229] As discussed above, the work for hire exception in the California Preservation Act is more limited.[230] Third, the statute of limitations period is slightly shorter in Massachusetts. An action must be brought within either two years of the harmful act or one year of discovery, whichever is longer.[231]

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[223] *Id.* (emphasis in original).

[224] *Id.*

[225] "Original," as used in the copyright law, has been understood to mean "owes its origin to the author." *See, e.g.*, Burrow-Giles Lithographic Co. v. Sarony, 111 U.S. 53, 57–58 (1884); Durham Indus., Inc. v. Tomy Corp., 630 F.2d 905, 910 (2d Cir. 1980); L. Baitlin & Son, Inc. v. Snyder, 536 F.2d 486, 490 (2d Cir. 1976), *cert. denied*, 429 U.S. 857 (1976).

[226] Representative Richard A. Gephardt (D-Mo.) recently introduced the Film Integrity Act of 1987, H.R. 2400, 99th Cong., 2d Sess., 133 CONG. REC. H3555 (daily ed. May 13, 1987). The bill would provide moral rights solely for motion pictures, disallowing any alteration including colorization without the written consent of the author. *See* 133 CONG. REC. E1922 (daily ed. May 13, 1987) (statement of Representative Gephardt).

[227] MASS. GEN. LAWS ANN. ch. 231, § 85S(c) (West Supp. 1986).

[228] CAL. CIV. CODE § 987(b) (West Supp. 1987).

[229] MASS. GEN. LAWS ANN. ch. 231, § 85S(b) (West Supp. 1986).

[230] CAL. CIV. CODE § 987(b) (West Supp. 1987); for the discussion of the work for hire exception in the Preservation Act, see *supra* text accompanying notes 178–81.

[231] MASS. GEN. LAWS ANN. ch. 260, § 2C (West Supp. 1987).

Fourth and finally, the Massachusetts statute contains a provision stating that if the artist has died the Attorney General of the Commonwealth may bring an action asserting the artist's rights on behalf of the public "with respect to any work of art which is in the public view."[232] This provision of the Massachusetts statute is analogous to landmark preservation laws authorizing the state or local government to bring suit to protect the community's interest in its cultural heritage.[233]

### B. *The Inadequacy of State Statutory Remedies*

The effort by three states to remedy through legislation the lack of a moral rights provision in the federal copyright law represents a step forward in the protection of artists and their works. The state laws are inadequate, however, as substitutes for a federal moral rights statute. Each of the three state laws is severely limited both in the range of protected works and in the rights granted. In addition to the specific failures of these three laws, more basic problems arise when the states attempt to fill the moral rights vacuum in this country by enacting their own protections. First, the state laws may be preempted by existing federal copyright laws; second, the state laws could conflict with a number of constitutional provisions; third, a complete defense to the application of the state laws may exist under federal copyright law; and fourth, jurisdictional disputes between states may arise due to the lack of uniformity between the state statutes.

The first issue in the enactment of any state law attempting to protect moral rights is whether the statute is preempted under the Supremacy Clause[234] by the federal copyright law. Although no court decisions have addressed this problem directly, there has been considerable, and conflicting, commentary regarding

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[232] MASS. GEN. LAWS ANN. ch. 231, § 85S(g) (West Supp. 1986). Since the Attorney General is authorized only to bring suit "on the artist's behalf," *id.*, it would appear that if artists waive their rights under the statute during their lifetime no action can be brought by the Attorney General. This outcome is unusual since the provision's apparent purpose is to benefit the public. The law, thus, allows the artist to waive the rights on behalf of the public. One commentator has criticized this result, arguing that an artist's waiver should not be a defense in a suit brought on behalf of the public. Gantz, *supra* note 32, at 888–89; *see also* Note, *supra* note 39, at 1226–27.

[233] *See, e.g.*, ILL. ANN. STAT. ch. 27, para. 2711 (Smith-Hurd Supp. 1986); KAN. STAT. ANN. § 75-2714 (1984); N.Y. PARKS REC. & HIST. PRESERV. LAW § 3.09(13) (McKinney 1984).

[234] U.S. CONST. art. VI, cl. 2.

the California Preservation Act.[235] Under the Copyright Act of 1976,[236] which includes a provision codifying the preemption doctrine,[237] a state law is preempted if it covers works within the subject matter of the copyright law and grants rights "that are equivalent to any of the exclusive rights within the general scope of copyright. . . ."[238] Since the works covered by state laws protecting moral rights are clearly within the subject matter of the copyright law, the crucial issue is whether the state law creates rights "equivalent" to those within the copyright law.

Unfortunately, the federal copyright law does not contain any definition of "equivalent." Moreover, since the enacted version of section 301 came from the floor of the Congress and replaced the originally proposed version of section 301, no useful legislative history is available. Courts and commentators, however, have suggested a two-part test to determine equivalency.[239]

The first test, known as the identical elements test, provides for preemption when the elements of the state cause of action are identical to those of any of the rights granted by the copyright law.[240]

Commentators have almost unanimously agreed that the California Preservation Act survives this part of the preemption analysis since in order to establish a violation of any of the rights protected by the law, a plaintiff must prove elements beyond those under any copyright law action.[241] For example, if a purchaser of art in California alters a work without the artist's consent and the creator still owns the copyright, the artist can file two causes of action. In California state court the artist can claim a violation of the Preservation Act,[242] while in federal court the artist can bring a suit under the copyright law

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[235] *E.g.*, 2 M. NIMMER, *supra* note 23, § 8.21[C]; Francione, *California Art Preservation Act and Federal Preemption by the 1976 Act—Equivalence and Actual Conflict*, 31 COPYRIGHT L. SYMP. (ASCAP) 105 (1984); Gantz, *supra* note 32, at 893–98; Note, *supra* note 39, at 1234–40; Note, *supra* note 32, at 497–99.

[236] 17 U.S.C. § 301(a) (1982).

[237] *Id.*

[238] *Id.*

[239] Allied Artists Picture Corp. v. Rhodes, 496 F. Supp. 408, 443 (S.D. Ohio 1980); Orth-O-Vision, Inc. v. Home Box Office, 474 F. Supp. 672, 684 (S.D.N.Y. 1979); Damich, *supra* note 32, at 1737–38; Francione, *supra* note 235, at 122–30; Gantz, *supra* note 32, at 896; Note, *supra* note 39, at 1234–37.

[240] Damich, *supra* note 32, at 1737–38; Francione, *supra* note 235, at 122–24; Gantz, *supra* note 32, at 896; Note, *supra* note 39, at 1234–37.

[241] Damich, *supra* note 32, at 1737–38; Francione, *supra* note 235, at 130–38; Gantz, *supra* note 32, at 897; Note, *supra* note 39, at 1237–38.

[242] CAL. CIV. CODE § 987 (West Supp. 1987).

for the unauthorized creation of a derivative work.[243] While most of the elements of proof in the two cases would be identical, the artist would have to show in the state court action that the work was one of "fine art" and "recognized quality."[244] Thus, ironically, the narrow limits of the California Preservation Act, New York Authorship Act, and Massachusetts statute[245] appear to save the laws from being preempted under the identical elements test.

The narrow limitations described above, however, do not appear to save the three statutes under the second test of equivalency. Under this analysis, a state law is preempted if its purpose and effect conflict with any of the provisions of the federal copyright law.[246] Although commentators are divided on whether the Preservation Act is preempted under this test,[247] the conflicts between state laws protecting moral rights and certain provisions of the copyright law appear insurmountable. Those arguing against preemption point to the different objectives of state moral rights legislation and the federal copyright law.[248] Under this view, moral rights laws seek to protect personality rights, which are completely separate from the economic rights guaranteed by the copyright law.[249]

This distinction loses its force, however, when considering the serious conflicts that may arise under the two sets of independent laws. For example, assume that an artist sold the copyright together with the artwork. If the purchaser wished to alter the work and create a derivative work without the artist's permission, the purchaser would be allowed to do so under the copyright law—which gives the holder the exclusive right to create derivative works. However, the artist could still bring a claim in California state court under the Preservation Act to

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[243] Damich, *supra* note 32, at 1737; Francione, *supra* note 235, at 124; Gantz, *supra* note 32, at 896; Note, *supra* note 39, at 1237.

[244] Damich, *supra* note 32, at 1744–47; Francione, *supra* note 235, at 125–30; Gantz, *supra* note 32, at 896–97; Note, *supra* note 39, at 1238.

[245] For a discussion of the limits of the Preservation Act, see *supra* text accompanying notes 171–77; of the limits of the Authorship Act, see *supra* text accompanying notes 200–06; of the limits of the Massachusetts statute, see *supra* text accompanying notes 218–25.

[246] Damich, *supra* note 32, at 1737–38; Francione, *supra* note 235, at 135–38; Gantz, *supra* note 32, at 897; Note, *supra* note 39, at 1238.

[247] Damich, *supra* note 32, at 1738; Francione, *supra* note 235, at 133–38; Gantz, *supra* note 32, at 897–98; Note, *supra* note 39, at 1237–38. *But see* 2 M. NIMMER, *supra* note 23, § 8.21[C].

[248] Damich, *supra* note 32, at 1737–38; Francione, *supra* note 235, at 124–30.

[249] *See supra* note 248.

prevent the alteration, assuming that the work were considered "fine art" of "recognized quality."[250]

This result—where a state law is used to prevent the exercise of a right unequivocally granted by the copyright law—creates serious problems as to the constitutionality of the state law. Although a state court might try to avoid this particular conflict by holding that the artist impliedly waived his state rights by selling the copyright, other difficulties are certain to arise. The California and New York legislatures perhaps anticipated this conflict and thus left the two laws largely silent as to what rights exist for works made "for hire."[251] The statutes do have provisions limiting their coverage if a work is produced under contract for advertising purposes.[252] Under federal law, however, the copyright in all works created pursuant to an agreement vests in the employer.[253] Thus, a conflict between state and federal law would arise in any state suit brought against an employer for alteration of works covered by the state statute. The Massachusetts legislation avoids this problem altogether by excluding all works produced by employees while in the scope of their employment.[254]

Even if the state laws were eventually upheld as constitutional, the mere uncertainty over the preemption issue and the fact that it is unlikely to be resolved in the near future by the Supreme Court deters states like New York from providing for more sweeping moral rights protection.[255] In addition, it may deter artists from vindicating their rights under the laws due to fears of protracted constitutional litigation.

The California Resale Act also raises preemption concerns, although in that context the argument against preemption appears to be stronger. In *Morseburg v. Balyon*[256] the Court of Appeals for the Ninth Circuit upheld the California Resale Act against a challenge on preemption grounds.[257] The court's holding, however, was explicitly limited to the 1909 copyright act,[258] although its analysis might be helpful in determining whether

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[250] CAL. CIV. CODE § 987 (b)(2) (West Supp. 1987).
[251] *See supra* text accompanying notes 178–79 & 211.
[252] CAL. CIV. CODE § 987(b)(2), (7); N.Y. ARTS & CULT. AFF. LAW § 14.03(3)(d) (McKinney Supp. 1987).
[253] 17 U.S.C. § 201(b) (1982).
[254] *See supra* note 229 and accompanying text.
[255] *See supra* note 199.
[256] 621 F.2d 972 (9th Cir. 1980).
[257] *Id.* at 977.
[258] *Id.* at 975.

the state royalty provision conflicts with the 1976 copyright law. Following the Supreme Court's analysis in *Goldstein v. California*,[259] the court in *Morseburg* found that the 1909 copyright act neither addressed resale royalties for artists nor evidenced hostility to resale royalties provisions, and that the California Resale Act did not seriously impair any rights granted under the 1909 copyright law.[260]

The reasoning in *Morseburg* could be extended to the 1976 copyright law. The only apparent conflict between the Resale Act and the 1976 federal copyright act concerns the right of resale granted by the federal law in section 109(a).[261] Unlike the California Preservation Act, the Resale Act does not prohibit the exercise of any of the rights granted by the copyright law. Rather, it merely makes exercising one of those rights slightly more expensive, much as a state tax on the sale of art would reduce the profits from a resale. If state action does not significantly burden the exercise of a federal right, as the Ninth Circuit found to be true of the Resale Act, the statute should be upheld.

On the other hand, the late Professor Nimmer took the position that the California Resale Act is preempted by federal copyright law and criticized the *Morseburg* court's reasoning in upholding the law.[262] In his view, any state law which inhibits the rights of reproduction, display, performance, or distribution protected by the copyright law is preempted since it meets the equivalency test of section 301.[263] Therefore, "the federal policy contained in the 'first sale' doctrine . . . may not be countered by a contrary state law, even though the state law's inhibition is by way of royalty rather than prohibition."[264]

In addition to possible preemption problems, other constitutional challenges to state moral rights and resale laws might be raised. For instance, in *Morseburg*, the plaintiff unsuccessfully claimed that the California Resale Act violated both the contract and due process clauses of the Constitution.[265]

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[259] 412 U.S. 546 (1973).
[260] 621 F.2d at 977.
[261] *See supra* notes 144–46 and accompanying text.
[262] 2 M. NIMMER, *supra* note 23, § 8.22[B]. Nimmer criticized the *Morseburg* court's preemption test—whether the state law merely provides an "additional right"—as allowing "state tinkering" with federal law. *Id.*
[263] *Id.*
[264] *Id. But see* Katz, *Copyright Preemption Under the Copyright Act of 1976: The Case of the* Droit de Suite, 47 GEO. WASH. L. REV. 200, 219–21 (1979).
[265] 621 F.2d at 978–80. The court found that the Resale Act did not seriously impair

As for moral rights legislation, a challenge might be brought under the takings clause. No court has had the opportunity to decide this issue. After the Supreme Court's decision in *Penn Central Transp. Co. v. City of New York*,[266] however, such a challenge will likely fail since the state statutes leave the owner of an artwork with valuable uses for the property.[267] Thus, it would seem that state moral rights statutes would survive any attack on constitutional grounds other than preemption.[268]

Enforcement of the state law is still subject to the provisions of the federal copyright law, even assuming that the basic moral rights protections granted by state law are not preempted by federal statute. For example, if a purchaser were sued for illegally altering a work under state law, the purchaser would be able to claim that the modification was a "fair use" under section 107 of the copyright law.[269] The state law could not constitutionally bar that defense if the work were copyrighted. Thus, any state moral rights statute is subject to federally granted defenses that may significantly impair the operation of the state's law.

Leaving moral rights legislation to the states may result in jurisdictional conflicts. To avoid the operation of California's Resale Act, which purchasers and sellers try to avoid as much as possible, sellers of art can simply obtain residency and finalize any sale in Nevada.[270] Similarly, owners of "fine art" living

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contractual obligations and that the state legislature had a valid public purpose rationale for enacting it. *Id.*

[266] 438 U.S. 104 (1978).

[267] *Id.* at 136 ("we must regard the New York City law as permitting Penn Central not only to profit from the Terminal but also to obtain a 'reasonable return' on its investment"). In fact, by requiring the artwork to remain unaltered, the laws would in most cases leave the owner with the use of the work that produces the greatest monetary value.

[268] The possibility remains that a purchaser altering a work would claim First Amendment protection for the alteration. The Supreme Court has recognized that symbolic speech is protected by the First Amendment. United States v. O'Brien, 391 U.S. 367, 376 (1968); Tinker v. Des Moines School District, 393 U.S. 503, 505 (1969).

[269] The "fair use" provision is particularly important in protecting parodies. 2 M. NIMMER, *supra* note 23, § 13.05[C]; Bernstein, *Parody and Fair Use in Copyright Law*, 31 COPYRIGHT L. SYMP. (ASCAP) 1 (1984). Some courts and commentators have also suggested that the provision alleviates possible conflicts between the First Amendment and the copyright law. Triangle Publications, Inc. v. Knight-Ridder Newspapers, Inc., 626 F.2d 1171, 1184 (5th Cir. 1980) (Tate, J., concurring); Dallas Cowboys Cheerleaders, Inc. v. Pussycat Cinema, Ltd., 604 F.2d 200, 205–06 (2d Cir. 1979); Wainright Securities, Inc. v. Wall Street Transcript Corp., 558 F.2d 91, 95 (2d Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978); Denicola, *Copyright and Free Speech: Limitations on the Protection of Expression*, 67 CALIF. L. REV. 283 (1979).

[270] *See Hearing*, *supra* note 5, at 106 (statement of Ron Feldman, co-director of Feldman Art Gallery in New York City).

in California or Massachusetts who wish to alter artwork could probably do so outside of those states without fear of suit.[271]

In addition, both the Massachusetts and California moral rights laws lack specificity on when a cause of action accrues, and thus raise difficult conflict of laws issues. For example, would a suit be allowed if an owner altered a work outside of Massachusetts, but moved into the Commonwealth with the altered work six months later? The New York Authorship Act avoids these problems, at the expense of full moral rights protection, by providing protection only to works publicly displayed within the state.[272]

The final reason why state moral rights laws are inadequate substitutes for federal legislation relates to the need for uniformity among state statutes. As demonstrated above, uniformity is critical if owners are to be prevented from evading the state laws. An even more important uniformity concern, however, comes from the federal copyright law. Although distinct from the economic rights protected by current copyright law, moral rights protection is inevitably intertwined with the rights granted by the copyright law. Since Congress has been delegated the constitutional power over copyright protection,[273] it should be Congress that decides whether to amend the copyright laws to include protections for artists' rights. Ad hoc determinations by state legislatures cause confusion similar to that which results when federal statutory and state common law causes of action are employed as substitutes for moral rights legislation.

The problems of preemption, general constitutional attack, overriding federal copyright defenses, jurisdictional disputes, and uniformity demonstrate the inadvisability of relying upon state legislation as the source of protection for artists. The delay and litigation costs associated with likely constitutional attacks upon the state laws further diminishes their usefulness. Further, as discussed above, even the provisions that have been enacted in California, New York, and Massachusetts, seriously underprotect artists' moral rights.

The only adequate solution to all of these concerns is the passage of legislation at the federal level to protect the economic

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[271] *Id.* at 99, 101.
[272] *See supra* notes 204–06 and accompanying text.
[273] U.S. CONST. art. I, § 8, cl. 8.

and personality rights of artists. Two bills now pending in Congress present that opportunity and deserve careful scrutiny.

## IV. The Congress Attempts to Respond

### A. *The Proposed Legislation*

In each of the last six Congresses, legislation has been introduced to amend the copyright law to include protection for artists' moral rights. The first bill was introduced in the House of Representatives in 1977 by then Representative Robert Drinan (D-Mass.).[274] The same legislation was reintroduced by Representative Drinan in 1979,[275] and then by Representative Drinan's successor, Representative Barney Frank (D-Mass.), in 1981 and 1983 (the "Frank bill").[276] Another bill was filed in the Senate in 1986 and again in 1987 with some changes by Senator Edward Kennedy (D-Mass.).[277] Companion legislation to the Kennedy bill was introduced by Representative Edward Markey (D-Mass.) in both the 99th and 100th Congresses.[278]

The Frank and Kennedy bills are distinct in several significant respects. The Frank bill attempts to grant broad moral rights protection to certain works of art, while the Kennedy bill mirrors the more limited approach to moral rights adopted by California, New York, and Massachusetts. Although the Kennedy bill goes further in that it seeks to amend the copyright law to grant resale royalty rights to artists, neither bill approaches the comprehensive moral rights protections granted to artists in civil law countries.

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[274] H.R. 8261, 95th Cong., 1st Sess., 123 CONG. REC. 22,733 (1977).

[275] H.R. 288, 96th Cong., 1st Sess., 125 CONG. REC. 440 (1979).

[276] H.R. 2908, 97th Cong., 1st Sess., 127 CONG. REC. 5689 (1981); H.R. 1521, 98th Cong., 1st Sess., 129 CONG. REC. H578–79 (daily ed. Feb. 17, 1983).

[277] S. 2796, *supra* note 1; S. 1619, *supra* note 1. The current version of the Kennedy bill is different in several respects from the 1986 version. *See, e.g., infra* notes 302, 307 & 319. Related bills have been filed in the House by Representative Thomas Downey (D-N.Y.), H.R. 4366, 99th Cong., 1st Sess., 132 CONG. REC. H1023 (daily ed. March 11, 1986), Representative Robert Kastenmeier, H.R. 1623, *supra* note 46, and Representative Richard A. Gephardt, H.R. 2400, *supra* note 226.

[278] H.R. 5722, *supra* note 1; H.R. 3221, *supra* note 1.

### 1. The Frank Bill

On February 17, 1983, the "Visual Artists Moral Rights Amendment" was introduced by Representative Barney Frank as H.R. 1521.[279] The bill was referred to a subcommittee of the House Judiciary Committee.[280] No hearings were ever held on the legislation.[281]

The proposed legislation would amend section 113 of the copyright law,[282] which deals with the rights granted to "pictorial, graphic, and sculptural works,"[283] by including a new subsection granting protection for certain moral rights.[284] "Pictorial, graphic, and sculptural works" are defined in section 101[285] of the copyright law to include "two-dimensional and three-dimensional works of fine, graphic, and applied art, photographs, prints and art reproductions, maps, globes, charts, technical drawings, diagrams, and models."[286] Thus, under the Frank bill, literary works and motion pictures would not receive moral rights protection. In contrast to the California and Massachusetts moral rights statutes, H.R. 1521 would grant moral rights protection to all "pictorial, graphic, and sculptural works" regardless of whether they are of "recognized quality."

The Frank bill would grant artists only two of the four traditional moral rights—a limited right of paternity and the right of integrity.[287] The right of the artist to claim authorship is absolute under the Frank bill,[288] as is the right "to object to any distortion, mutilation, or other alteration" of the work.[289] However, the Frank bill limits the right of paternity by providing that an artist may demand to have his or her name removed from a work. The rights granted by the bill could be asserted by the author

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279 H.R. 1521, *supra* note 276.
280 *Id.*
281 Representative Frank did not reintroduce the "Visual Artists Moral Rights Amendment" in the 99th Congress and does not plan to do so in the 100th Congress, because he is no longer a member of the House Judiciary subcommittee which would consider the legislation, and because of the failure to report the bill out of the subcommittee during both the 97th and 98th Congresses. Telephone interview with Dorothy Reichard, District Director to Representative Barney Frank (November 10, 1987).
282 H.R. 1521, *supra* note 276, § 2.
283 *Id.*
284 *Id.*
285 17 U.S.C. § 101 (1982).
286 *Id.*
287 H.R. 1521, *supra* note 276, § 2.
288 *Id.*
289 *Id.*

"or the author's legal representative" during the life of the author and for fifty years after his or her death.[290]

This bill, however, leaves four important questions unanswered. First, the bill is silent on whether negligence, gross negligence, or intentional misconduct must be shown in order for an alteration to be actionable. Under the current copyright law, a showing of mere negligence is generally sufficient to establish a violation of the statute. The copyright law discriminates between negligent and willful infringement only by adjusting the appropriate damage award granted to the copyright owner.[291]

The second question unanswered by the Frank bill is whether an artist can waive the rights granted by the legislation. In the absence of a statutory prohibition of waiver, it is likely that freedom of contract principles would apply, and thus it would appear that artists could waive the rights granted by H.R. 1521.

The third issue unresolved by the Frank bill is whether a defense of "fair use" is available to violators of the legislation. Since the "fair use" provision of the copyright law[292] applies "[n]otwithstanding the provisions of section 106,"[293] and since the Frank bill would only affect section 113,[294] a strong argument can be made that the "fair use" section of the copyright law is inapplicable in any moral rights infringement action.

Finally, the Frank bill is not explicit on whether an artist who no longer owns the copyright in a work may assert the rights of paternity and integrity granted by the legislation. The Frank bill states only that the rights granted operate "[i]ndependently of the author's copyright."[295] Thus, it would appear that an artist retains the moral rights protections even if the copyright is transferred to the purchaser. If this were true, an artist producing a work "for hire" could still assert the rights granted by the bill, unless the artist agreed to waive these rights.

### 2. The Kennedy Bill

The most recent proposed federal legislation, first introduced by Senator Kennedy in September 1986[296] and then again in

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[290] *Id.*
[291] 17 U.S.C. § 504(c) (1982).
[292] *Id.* § 107.
[293] *Id.*
[294] *See* H.R. 1521, *supra* note 276, § 2; *see also supra* note 281 and accompanying text.
[295] H.R. 1521, *supra* note 276, § 2.
[296] S. 2796, *supra* note 1.

August 1987,[297] would recognize both moral and resale rights for artists. The proposal, according to Senator Kennedy, "recognizes the implicit originality of individual works of fine art, the public benefit of encouraging a creative environment for artists to work, [and] the national responsibility to enrich and enliven our cultural heritage."[298]

The Kennedy bill would amend section 106 of the copyright law,[299] which currently details the exclusive rights available to the copyright holder, by adding subsections granting limited rights of integrity and paternity to artists.[300] In addition, the amended section 106 would provide artists with resale rights.[301]

The right of integrity contemplated by the Kennedy bill is very limited. The bill would require a showing of grossly negligent or intentional conduct resulting in "the significant or substantial distortion, mutilation, or other alteration" of a publicly displayed work.[302] As under the Frank bill, only "pictorial, graphic, and sculptural works" would be protected from alteration.[303]

An additional limitation in the Kennedy legislation is the requirement that "destroyed" artworks be "work[s] of fine art"[304] in order to receive protection. As with the California Preservation Act, the determination of quality is left to "a court or other trier of fact"[305] based upon "opinions of artists, art dealers, collectors of fine art, curators of art museums, restorers and conservators of fine art, and other persons involved with the creation, appreciation, history, or marketing of fine art."[306] This "quality" test is particularly disturbing since no such test has ever before been incorporated into federal copyright law.[307]

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[297] S. 1619, *supra* note 1.

[298] S. 2796, *supra* note 1, appendix to bill submitted by Senator Kennedy.

[299] S. 2796, *supra* note 1, § 3.

[300] *Id.*

[301] *Id.*

[302] *Id.* The same standard would apply to the "destruction" of a work, although the work need not be publicly displayed for there to be a cause of action for destruction. *Id.* The public display requirement in S. 1619 was not present in S. 2796 and significantly impairs the effectiveness of the more recent legislation. Under the current bill, artwork that is not publicly displayed can be "substantially altered" without the artist having any recourse.

[303] H.R. 1521, *supra* note 276, § 3; S. 1619, *supra* note 1, § 3.

[304] S. 1619, *supra* note 1, § 3.

[305] CAL. CIV. CODE § 987(f) (West Supp. 1987); S. 1619, *supra* note 1, § 2.

[306] S. 1619, *supra* note 1.

[307] The original Kennedy bill, S. 2796, would have applied this quality test to all claims for protection of the integrity right, not just for acts of "destruction." *Supra* note 1, § 3. However, at the hearing on S. 2796 several witnesses complained bitterly about this requirement. *Hearing*, *supra* note 5, at 29 (statement of Gustave Harrow); *id.* at 38–39 (statement of Martin Bressler, founder and vice-president of Visual Artists and

While the California legislature's inclusion of a quality test has no impact on federal copyright law, the inclusion of such a test in section 106 might lead to the inclusion of similar tests in other sections of the federal copyright law.

The Kennedy bill provides that even if the artist no longer owns the copyright "he shall still have the exclusive right during his lifetime, and the estate of such author shall have the exclusive right for up to 50 years after the death of such author, to assert infringement of the copyright [by distortion, mutilation, or other alteration]."[308] The owner of a copyright may assert the right of integrity only if he or she is also the author of the work.[309] Apparently, the purpose of this limitation is to prevent purchasers of art from obtaining control over the artist's right of integrity by transfer and then separating the copyright in the work from the corresponding integrity right. Although the right of integrity provision in the bill does not mention works produced for hire, the provision granting the integrity right even if the copyright is transferred suggests that works for hire are fully covered by the bill's right of integrity.

The other moral right protected by the Kennedy bill is the right of paternity. As with the Kennedy bill's right of integrity, the paternity right survives for the life of the artist and for fifty years after the artist's death[310] and only applies to "pictorial, graphic, or sculptural works."[311] Moreover, only works of "fine art" are covered by this provision.[312]

The Kennedy bill limits the artist's ability to claim or disclaim authorship to those situations where the work is publicly displayed and is distorted, mutilated, or altered.[313] Thus, under the Kennedy bill an artist whose work was not altered but simply placed in a surrounding that artist considered to be offensive would be as unsuccessful under the Kennedy bill as were the *Shostakovich* plaintiffs under New York common law.[314]

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Galleries Association, Inc.); *id.* at 129 (statement of Tad Crawford, on behalf of the American Society of Magazine Photographers, the Bay Area Lawyers for the Arts, the Graphic Artists' Guild and the Society of Illustrators).

[308] S. 1619, *supra* note 1, § 3.

[309] *Id.* § 3.

[310] *Id.*

[311] *Id.*

[312] *Id.*

[313] *Id.*

[314] *See supra* notes 149–52 and accompanying text.

Under the Kennedy bill, the paternity right applies "whether or not [the author] is the copyright owner."[315] Thus, it appears that for hire works that are not produced pursuant to such a contract would qualify for the right of paternity.

Even if a work does meet the Kennedy bill's requirements for moral rights protection, the legislation limits that protection when the work, a mural for example, is attached to a building. As under the California Preservation Act, if the work cannot be removed from the building without "distortion, mutilation, or other alteration of such work," then the artist's rights of paternity and integrity are deemed waived.[316] An artist can preserve these rights only if they are "expressly reserved by an instrument in writing signed by the owner of such building . . . and properly recorded. . . ."[317]

In addition to providing limited moral rights protection, the Kennedy bill would amend section 106 of the copyright law to include a provision granting artists resale royalties equal to seven percent of the difference between the seller's purchase price and the resale price.[318] This royalty right would extend for the life of the artist and for fifty years thereafter, with any royalty due following the artist's death to be paid to the estate of the author.[319] The law does not apply to resales for a price of less than $1000 or to resales where the price received is less than 150 percent of the seller's original purchase price.[320]

The bill does prohibit the artist from waiving the resale rights granted under the law, much like the California Resale Act.[321] Interestingly, the Kennedy bill does not state whether the paternity and integrity rights granted by the bill would similarly be waivable. This silence is unusual, since the California and Massachusetts moral rights laws, on which Senator Kennedy stated that his bill was based,[322] explicitly permit waiver of the

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[315] S. 1619, *supra* note 1, § 3.
[316] *Id.* § 4.
[317] *Id.*
[318] *Id.* § 3.
[319] *Id.* In S. 2796, posthumous royalties were to be given to the National Endowment for the Arts. S. 2796, *supra* note 1, § 3. However, there was significant opposition to this proposal at the hearing on the bill, *Hearing*, *supra* note 5, at 23 (statement of John Raimondi, artist); *id.* at 41 (statement of Thomas M. Goetzl, professor of law at Golden Gate University); *id.* at 109–12 (letter from Paula Cooper to Sen. Kennedy), and it was changed in S. 1619. S. 1619, *supra* note 1, § 4.
[320] S. 1619, *supra* note 1, § 3.
[321] *Id.*; *see also supra* text accompanying notes 193–94.
[322] *Hearing*, *supra* note 5, at 2 (statement of Sen. Kennedy).

integrity and paternity rights.[323] Unless legislative history demonstrates a contrary intention, courts will likely reason from the explicit prohibition of waiver as to the resale right and the lack of any corresponding provision with respect to the integrity and paternity rights that waiver of the latter rights is lawful.[324]

While the resale right is not waivable, it can be assigned under the Kennedy bill,[325] although "such assignment shall not have the effect of creating a waiver prohibited by this subsection."[326] While enforcing a no-waiver provision in a statute is difficult, it would seem almost impossible to permit assignments while at the same time enforcing a prohibition on waiver. The Kennedy bill states that the resale right "shall not apply to . . . any author who has not registered as an author with the Copyright Office prior to that resale."[327] Thus, any artist wishing to waive the resale right may do so by simply failing to register with the Copyright Office or by not complying with the registration regulations established by the Register of Copyrights.

### B. *The Successes and Failures of the Proposed Federal Legislation*

The Frank and Kennedy bills each offer the possibility of a dramatic step forward in the protection of moral rights for artists in the United States. Both bills overcome many of the problems that arise from trying to protect moral rights through the use of substitute state and federal causes of action and state moral right statutes.

Nevertheless, both of the congressional moral rights bills fail to ensure adequate protection for artists' personality rights. As discussed above, only limited classes of works are protected by the proposed federal legislation. In addition, neither proposed bill addresses the waiver of paternity and integrity rights, and only the Kennedy bill grants limited royalty rights to artists.[328]

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[323] *See supra* text accompanying notes 180 & 221.

[324] *See Hearing*, *supra* note 5, at 123 (statement of Tad Crawford, on behalf of the Graphic Artists Guild Council and the Society of Illustrators and Magazine Photographers, arguing for an explicit prohibition in the bill regarding waiver of rights).

[325] S. 1619, *supra* note 1, § 3.

[326] *Id.*

[327] *Id.*

[328] *Id.*

The limited breadth of the works included in the proposed bills seriously impairs their effectiveness. For example, since neither bill applies to "motion pictures," the Monty Python group would have still had to rely on section 43(a) of the Lanham Act. Yet both resolutions purport to be "Visual Artists Rights Bills."

There may be several practical reasons for the narrow scope of the two bills. One such reason may be that because of the lobbying strength of the industries and individuals who might be affected, a more expansive moral rights statute would be unlikely to pass. In particular, publishers, motion picture producers, and broadcasters would all appear to be adversely affected by an expansive moral rights provision.[329] As one commentator has noted, "[t]heir interest lies in deriving economic advantage from the created work. This interest is recognized and protected by the copyright law."[330] Any attempt to inhibit the exploitation value of copywritten material would be strenuously opposed by these powerful interests.

Two additional reasons relating to possible enforcement problems may explain the limited scope of the federal bills. First, it is often difficult to determine who is the creator of a work for the purpose of granting moral rights protection. In the case of paintings, sculptures, and photographs, that question is usually answered quite easily since only one person is generally involved in the creative effort. Conversely, the production of movies, books, and phonograph recordings often involve numerous creative talents. Issues of who can claim (and possibly waive) the personality rights might arise under legislation with a broader scope. The second possible reason for the limited scope of the Frank and Kennedy bills stems from First Amendment concerns which might arise in conflicts between artists and museums over display of works or between writers and producers.[331] For example, disputes might arise between playwrights

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[329] Roeder, *supra* note 36, at 577; *see also* Gantz, *supra* note 32, at 888. The opposition of these groups to moral rights protection, *see Hearing on H.R. 1623*, *supra* note 46 (statement of the Motion Picture Ass'n); *id.* (statement of Kenneth W. Dam, vice president of IBM Corp.), has apparently been a significant factor in the failure of this country to join the Berne Convention. *See* COPYRIGHT LAW REVISION STUDY 1, *supra* note 44, at 11; Nimmer, *supra* note 44, at 523–24. By limiting the scope of their bills, both Representative Frank and Senator Kennedy appear to have avoided directly affecting the interests of these powerful industries.

[330] Roeder, *supra* note 36, at 577.

[331] Tribe, *First Amendment Endgame*, Boston Globe, Dec. 15, 1984, at 19, col. 4 (First Amendment should fully apply to protect producer's right to perform modern stage version of Beckett's *Endgame*); *see also supra* note 268.

and directors over differing interpretations of a work. The First Amendment problems appear most threatening when granting moral rights to novelists, playwrights, and directors—all of whom produce works that are directly protected by the First Amendment. The limited coverage of the Frank and Kennedy bills—which provide protection only to visual artists—avoids the most likely First Amendment challenges.

### C. *The Need for Federal Legislation*

Despite the many problems with the Kennedy and Frank bills, there are overwhelming reasons why Congress must grant moral rights to artists. An especially important justification for moral rights protection, as the Kennedy bill recognizes, is the need to preserve our artistic culture for future generations.[332] The evolving recognition in this country during the last two decades of the need to prevent the alteration of artwork parallels the rise of state landmark preservation laws across the country.[333] While the landmark preservation movement has to date been far more successful than the moral rights movement,[334] the enactment of either the Kennedy or the Frank bill would result in far greater federal involvement in the preservation of our artistic heritage than has ever occurred with regard to landmark preservation.[335]

Another important reason for enacting expansive federal moral rights protection is the need for the United States to become a signatory to the Berne Convention. The Secretary of State has recently urged Senate ratification of the Berne Convention,[336] and he has received the support of three interested

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[332] *Kennedy Bill Aims to Boost Artists' Rights*, AM. SOC. OF MAG. PHOTOGRAPHERS BULL. 4 (Aug. 1986) (statement of Senator Kennedy) [hereinafter *Artists' Rights*]. Surprisingly, the current version of the Kennedy bill undermines the force of this justification by requiring, unlike in the original Kennedy bill, a showing that the work was "publicly displayed" in order to assert the right of integrity. S. 1619, *supra* note 1, § 3.

[333] "[A]ll 50 states and over 500 municipalities have enacted laws to encourage or require the preservation of buildings and areas with historic or aesthetic importance." Penn Central Transp. Co. v. City of New York, 438 U.S. 104, 107 (1978).

[334] *E.g., id.*

[335] National Historic Preservation Act, Pub. L. No. 89-665, 80 Stat. 915 (1966), *amended by* National Historic Preservation Act Amendments of 1980, Pub. L. No. 96-515, 94 Stat. 2987 (1980) (codified at 16 U.S.C. § 470 (1985)). The Historic Preservation Act envisions equal cooperation between federal, state, and local governments. 16 U.S.C. §§ 470–471. In contrast, by amending the copyright law, Congress would seemingly preempt state attempts to grant moral and resale rights to authors.

[336] S. TREATY DOC. No. 27, 99th Cong., 2d Sess. I, III–IV (1986) (Secretary of State's Letter of Submittal to the Senate of the United States (June 4, 1986)).

agencies—the Copyright Office, the Patent and Trademark Office, and the Office of the United States Trade Representative.[337] President Reagan submitted the convention to the Senate for ratification stating that "[w]hen we are urging other countries to enhance copyright protection, the United States can no longer remain outside the Berne Union. It is, therefore, a matter of some urgency that the United States finally join the Berne Convention."[338]

Congress should follow the lead of most of the other western nations of the world[339] and approve a broad moral rights law. Such legislation should cover most, if not all, of the works entitled to the protections of the copyright law. In addition, it should prohibit the waiver of the personality rights granted to the author,[340] provide that negligent alteration or mutilation is sufficient to infringe the creator's rights,[341] and grant meaningful resale royalty rights to artists.

By passing such comprehensive moral and resale rights legislation, the Congress could, as Senator Kennedy has stated, "bring the dawn of new opportunity, recognition, and prosperity for artists."[342] As a result, a sculptor such as Alexander Calder could prevent his works from being repainted without his permission from the original black and white to the green and gold

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[337] *Id.* at XIII (Letter of Submittal) (stating that these three agencies support the bill); *see also Hearings on United States Adherence to the Berne Convention Before the Subcomm. on Patent, Copyright and Trademark of the House Comm. on the Judiciary*, 99th Cong., 2d Sess. 52 (1987) (statement of Donald C. Curran, Acting Registrar of Copyrights, Library of Congress); *id.* at 115 (statement of Donald J. Quigg, Acting Commissioner for Patents and Trademarks, Patent and Trademark Office); *id.* at 135 (statement of C. Michael Hathaway, Deputy General Counsel, United States Trade Representative).

[338] S. TREATY DOC. NO. 27, *supra* note 336, at I. Whatever disagreement may exist over whether current United States law would satisfy the Berne Convention, *see supra* note 46, there is little doubt that the Kennedy bill would be "entirely consistent" with the convention. *Hearing*, *supra* note 5, at 93 (statement of John Koegle, on behalf of Volunteer Lawyers for the Arts).

[339] Over 60 countries now have moral rights laws, *Monty Python Litigation*, *supra* note 11, at 615, and 76 countries adhere to the Berne Convention, S. TREATY DOC. NO. 27, *supra* note 336, at III (listing the countries adhering to the Berne Convention).

[340] By prohibiting waiver of the artist's rights, Congress also ensures that the public benefit of the law—preservation of the artistic culture—would not be undercut by artists selling their personality rights.

[341] *But see Hearing*, *supra* note 5, at 101 (statement of John Koegle, on behalf of Volunteer Lawyers for the Arts, arguing for the more restricted scope of the Kennedy bill).

[342] *Artists' Rights*, *supra* note 332, at 4 (statement of Senator Kennedy). Of course, it is not clear that the Kennedy bill will bring a new "prosperity" to artists. In fact, some may argue that the law will cause a shifting of rights with artists ending up no better off and possibly worse off. *See, e.g.*, Weil, *supra* note 43.

colors of the county where the sculpture is located.[343] Moreover, an artist such as Jasper Johns would be assured of receiving some compensation when one of his paintings, purchased for $2,250 twenty-seven years earlier, is resold for $3.63 million.[344] In the end, all citizens would benefit as America's artistic culture is preserved for the benefit of present and future generations.

## IV. CONCLUSION

Attempts to protect the personality rights of artists in this country have largely turned upon the use of substitute causes of action at both the federal and state level. The most renowned case to date remains the 1976 Second Circuit decision in *Gilliam v. American Broadcasting Cos.*[345] While many anticipated that the case would result in a significant advance in the protection of artists' moral rights, little progress has actually been achieved through either statutory or common law suits during the eleven years since the decision.

Instead, in the years since the *Gilliam* holding considerable advances have been made at the state level. Three states have approved moral rights legislation, and one state has enacted an artists' resale royalty provision. However, these three state moral rights' laws are restricted in their scope and serious questions have been raised about their ability to withstand constitutional preemption challenges. As a practical substitute for national moral rights legislation, the state laws fail in much the same manner as the patchwork of common law and federal statutory causes of action currently employed by artists.

The only effective solution to the problem of inadequate protection for creative works is for Congress to enact legislation. Although the two bills introduced in the Congress in the last ten years are nearly as limited in their scope as the California, New York, and Massachusetts moral rights statutes, the proposals represent an opportunity to incorporate protections for artists directly into the copyright law. This opportunity comes at a time when considerable academic, judicial, and state legislative at-

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[343] Gantz, *supra* note 32, at 873. Numerous other examples of alteration and destruction of artwork without the artist's consent have been documented. *See supra* note 39.
[344] N.Y. Times, Nov. 23, 1986, § 4, at 26. col. 1.
[345] 538 F.2d 14 (2d Cir. 1976).

tention has been paid to the issue of artists' moral rights. Most importantly, enactment of either the Kennedy or the Frank bill would remove a major obstacle to United States participation in the Berne Convention. As a result, the United States would no longer be one of the few western nations that refuses to protect artists' moral rights.

# NOTE

# THE FAILURE OF FREE CONTRACT IN THE CONTEXT OF EMPLOYER-SPONSORED RETIREE WELFARE BENEFITS: MOVING TOWARDS A SOLUTION

JOHN THACHER MCNEIL*

*This Note explores the American legal system's failure to protect a critical element of many retired people's health care: employer-sponsored retiree health plans. In the last ten years, many employers seeking to cut their costs of production have modified or terminated the retiree health plans they sponsor. Despite the fact that retirees earned these promised retirement benefits through years of service and had relied on the promise of these benefits to plan for their future, employers have been able to slip by the few legal barriers to plan termination. In some instances, employers have manipulated flaws in the present system of court-enforced contract to coerce retired people to settle for less comprehensive benefit plans.*

*This Note also considers the failure of the legal system to meet the needs of employers in the midst of a long-term economic crisis. The law controlling retiree benefit plans has been unable to balance effectively their financial needs with the health care needs of their former employees. Employers have been forced to resort to breaching contracts or declaring bankruptcy in order to avoid the heavy burdens of their retiree benefit programs.*

*In addition to analyzing and criticizing the current legal framework for the provision and termination of employer-sponsored retiree benefits, this Note presents a proposal for reform of this framework. The primary premise of the proposal is that the use of a free contract system for the provision and termination of benefits has benefited no one. Free contract has led to irrational planning, frustrated expectations, and a greater reliance on the public fisc for the provision of medical insurance for the elderly.*

When Congress passed the Employee Retirement Income Security Act (ERISA)[1] in 1974 it left retiree welfare plans[2] free of

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[1] Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified as amended at 29 U.S.C. §§ 1001–1461 (1982)).

[2] ERISA defines retiree welfare plans to include health, death, disability, unemployment, and vacation benefits, as well as a number of other benfits. 29 U.S.C. § 1002(1) (1982). This Note is primarily concerned with the health benefit portion of these welfare plans.

most of the constraints it imposed on qualified pension plans.[3] ERISA requires qualified pension plans to vest after a certain length of time,[4] to meet minimum pre-funding standards,[5] and to meet disclosure and reporting standards.[6] It also imposes fiduciary responsibilities on plan administrators.[7] In contrast, neither ERISA nor any other federal law imposes significant requirements on retiree welfare plans. ERISA imposes only fiduciary responsibilities and disclosure and reporting standards on retiree welfare plan administrators.[8] By imposing so few requirements on welfare benefit plans, Congress essentially left the creation, administration, and termination of these plans to free contract.[9]

In the years since Congress passed ERISA, and most dramatically in the last six years, firms in heavy industry, especially large-scale manufacturing and mining companies, have sought ways to lower costs in order to weather long-term economic decline.[10] Some firms have diversified, while others have simply cut production. Other cost-saving measures have included laying off workers, closing unprofitable plants, and seeking wage concessions from employees.[11] In this cost-cutting process, many firms have terminated or modified retiree welfare plans with the hope that either they will not be held liable to continue providing benefits promised or that they can convince their retirees to settle for a less costly benefit plan.[12]

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[3] ERISA defines pension plans to include those "established or maintained by an employer or by an employee organization, or by both . . . [which]: (i) provide[] retirement income to employees, or (ii) result[] in a deferral of income by employees for periods extending to the termination of covered employment or beyond. . . ." 29 U.S.C. § 1002(2) (1982).

[4] *Id.* § 1053.

[5] *Id.* § 1082.

[6] *Id.* §§ 1021–1031.

[7] *Id.* §§ 1101–1114.

[8] *Id.* § 1082.

[9] In essence, ERISA determines only the form of the communication between the employer and the employee concerning welfare benefits. It does not control the content of the contract as it does for pensions. Congress chose to distinguish pension benefits from welfare benefits because "to require vesting of these ancillary [welfare] benefits would seriously complicate the administration and increase the cost of plans whose primary function is to provide retirement income." H.R. Rep. No. 807, 93d Cong., 2d Sess. 60, *reprinted in* 1974 U.S. Code Cong. & Admin. News 4093, 4726. This Note challenges the fundamental assumption by Congress that retirement income can be protected without providing protection for retirees' health care benfits.

[10] This is especially true in the steel and automobile industries. *See* Vogel, *Until Death Do Us Part: Vesting of Retiree Insurance*, 9 Indus. Rel. L.J. 183, 199–200 (1987).

[11] *Id.* at 200 n.98.

[12] For a thorough list of cases involving termination or modification of retiree welfare plans, see *id.* at 184.

These terminations and modifications of benefit plans have left tens of thousands of retirees with either no medical insurance or with less than half the coverage they had expected to have when they retired.[13] Litigation over these benefits has left many retirees in limbo, not knowing whether to expect coverage in the future. Many elderly people have either done without or postponed important treatment in the hope that their benefits will be restored or that they will qualify for Medicare before needed treatment becomes a matter of life or death.[14]

The plight of retirees who have had their welfare benefits terminated has attracted increasing national attention. The LTV Corporation's sensational bankruptcy and its attempts to terminate its retiree benefits plan brought national press coverage to the issue.[15] Academic commentators have recently considered the law surrounding the rights of employers to terminate or amend welfare benefit plans and the rights of employees to receive promised benefits.[16]

Congress has also addressed these issues on two levels. In the last few years, several committees in Congress have held hearings on the subject of retiree health plans.[17] In addition, the full body of Congress has considered a number of piecemeal and stop-gap solutions to aid retirees. These stop-gap proposals have included amendments to several statutes including ERISA,

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[13] There has yet to be an accurate calculation of the number of retirees who have had benefits terminated or modified, yet a number of litigated cases concerning these terminations have involved thousands of retirees. *See id.* In the bankruptcy of LTV Corporation, for example, 78,000 retirees were threatened with termination of their benefits. *See* 132 CONG. REC. S16,845 (daily ed. Oct. 16, 1986) (statement of Sen. Boschwitz (R-Minn.)). *See also Retiree Health Benefits: The Fair-Weather Promise: Hearings Before the Senate Special Comm. on Aging*, 99th Cong., 2d Sess. 107 (1986) [hereinafter *Fair Weather Promise*]. Approximately nine million retirees and their dependents are currently exposed to plan termination or modification. *See Corporate Retiree Health Benefits: Here Today, Gone Tomorrow?: Hearing Before the House Select Comm. on Aging*, 98th Cong., 2d Sess. 100, 102 (1984) [hereinafter *Here Today, Gone Tomorrow?*].

[14] *See Here Today, Gone Tomorrow?*, *supra* note 13, at 5–6, 60; *see also* Mamula v. Satralloy, Inc., 578 F. Supp. 563, 577 (S.D. Ohio 1984).

[15] *See Fair Weather Promise*, *supra* note 13, at 107.

[16] *See, e.g.*, Barnes & Mishkind, *Retiree Health and Welfare Benefits: Controversy Over Their Duration*, 10 EMP. REL. L.J. 584 (1985); Rabkin, *Recent Developments in Retiree Health Benefits*, 36 LAB. L.J. 675 (1985); Van Olson, *Nonpension Retiree Benefits: Are They For Life? Management Guidelines to the Issue*, 36 LAB. L.J. 402 (1985); Vogel, *supra* note 10.

[17] *See, e.g.*, *Here Today, Gone Tomorrow?*, *supra* note 13; *Fair Weather Promise*, *supra* note 13; *Retiree Health Benefits: Hearing Before Senate Subcomm. on Savings, Pensions & Investment Policy of the Senate Comm. on Finance*, 99th Cong., 1st Sess. (1985) (hearing to consider funding options and tax incentives for welfare plans) [hereinafter *Retiree Health Benefits*].

the National Labor Relations Act (NLRA),[18] and the Bankruptcy Code.[19] To date, however, only one temporary measure has been enacted into law.[20]

Despite interest in the problem of retiree welfare benefits, no analysis has provided a framework for a substantial legal reform. Hearings before Congress and the articles addressed to the subject have explored the existing legal scheme in some detail, yet neither have produced a solution which would satisfy the needs of present retirees, future retirees, and employers.[21] This Note argues that the fundamental problem with the present retiree benefit scheme is that it is based on principles of free contract. The Note frames the critical issue as a matter of how far beyond free contract Congress must go to assure both active workers and retired people that their employers will fulfill promises of retiree welfare benefits.

In dealing with this issue, this Note first describes the extent of the present problem and its ramifications for the future. It then explores the current legal structure under which benefits are provided. The Note goes on to highlight the problems with this structure.

This Note also proposes a two-stage solution. The first stage focuses on solving the problems of current retirees. The Note proposes modest amendments to a number of federal statutes. These amendments should provide retirees with more effective remedies when employers terminate their welfare plans. These remedies should discourage employers from modifying or terminating plans unilaterally.

The second stage focuses on creating an entirely new legal scheme to govern retiree benefits. It is aimed at meeting the needs of the next generation of retirees. The Note defines the goals of the new benefits system as well as the political and economic considerations that must constrain it. The second stage solution recognizes that the law must balance employers' need for financial flexibility with employees' need for security.

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[18] Ch. 372, 49 Stat. 449 (1935) (codified as amended at 29 U.S.C. §§ 151–169 (1982)).

[19] 11 U.S.C. §§ 1–151326 (1982). *See infra* notes 151–53 and accompanying text.

[20] Pub. L. No. 99-656, § 2, 100 Stat. 3668 § 2 (1986) was passed at the end of the 99th Congress to keep employers petitioning for bankruptcy from terminating welfare benefit plans while Congress considers an amendment to the Bankruptcy Act. This measure expired in May of 1987.

[21] The most recent and most exhaustive coverage of this subject has been by Professor Vogel, yet her proposals for legislative change attempt only to patch up the current system of free contract and do not highlight the fundamental flaws with this system. *See* Vogel, *supra* note 10, at 234.

In this context, the Note then proposes a regulated tax expenditure program which strikes the necessary balance between flexibility and security.[22]

## I. Scope of the Welfare Benefits Problem

### A. *The Tip of the Iceberg: Present Problems*

Despite the fact that Medicare[23] is the second largest domestic spending program,[24] it covers less than half the health care costs of retired people. Medicare covers approximately forty to forty-five percent of the medical costs of people aged sixty-five and older.[25] However, the program provides no aid to retired persons under age sixty-five,[26] nor does it cover the significant costs of long-term care or catastrophic illness.[27] Even with Medicare coverage, most retirees spend between twelve and thirty-three percent of their income on medical costs.[28]

Employer-sponsored retiree benefit programs fill critical gaps in Medicare coverage. Approximately one-sixth of all retirees in the United States receive medical insurance under a welfare benefit plan.[29] These plans often provide full medical coverage

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22 The solutions proposed in the first two stages focus on employer-sponsored plans. This Note does not attempt to solve the problems of all elderly people who are without health benefits. In fact, one of the conclusions of this Note is that no single solution other than a radical expansion of Medicare or Social Security could solve the problems of all retirees. The problems of the indigent, the uninsured or under-insured, and the uninsurable are also not addressed. However, they do present Congress with a very pressing, albeit different, problem than employees covered by employer benefit plans.

23 Health Insurance for the Aged and Disabled, Pub. L. No. 89-97, 79 Stat. 290 (1965) (codified as amended at 42 U.S.C. §§ 1395–1396(d) (1982), and in scattered sections of 26 U.S.C. and 45 U.S.C.).

24 Medicare accounts for seven percent of domestic spending. Only the Social Security program accounts for a larger percentage of domestic spending. *See* SENATE SPECIAL COMM. ON AGING, DEVELOPMENTS IN AGING, S. REP. No. 242, 99th Cong., 1st Sess. 166, 173 (1985) [hereinafter DEVELOPMENTS IN AGING].

25 *Id.* at 175.

26 42 U.S.C. § 1395(c)(1) (1982).

27 *Id.* § 1395(d). *See also Retiree Health Benefits*, *supra* note 17, at 106. Medicare does not cover Alzheimer's disease, prolonged illnesses caused by heart disease, hearing aids, eyeglasses, home care, drugs, dental care, foot care, and routine physical exams. *See* Pepper, *Lifting the Medical-Cost Cloud from the Elderly*, Boston Globe, Apr. 27, 1987, at 15, col. 1.

28 *Compare* the statistics in DEVELOPMENTS IN AGING, *supra* note 24, at 175, *with* those in *Fair Weather Promise*, *supra* note 13, at 94.

29 DEVELOPMENTS IN AGING, *supra* note 24, at 213. Almost all these benefits are provided by employers with relatively large workforces. *Fair Weather Promise*, *supra* note 13, at 94.

to retirees under age sixty-five.[30] For retirees aged sixty-five and older, the plans often cover all medical costs not covered by Medicare.[31]

Retiree medical benefit programs comprise a significant portion of many employers' payroll expenditures. On average, employers who provide retiree welfare benefit plans[32] devote between three and five percent of their payroll to such benefits. These plans cost between $2000 and $5000 per year for each retiree who is ineligible for Medicare.[33] Company group health insurance for retirees eligible for Medicare costs between $600 and $1500 per year for each retiree.[34]

Retirees over sixty-five who are covered by Medicare but not by employer-sponsored health insurance spend up to a third of their income on additional coverage or on out-of-pocket medical costs.[35] Retirees who are covered by company plans spend half of that amount in out-of-pocket medical costs.[36] Retired couples aged sixty-two to sixty-four who have neither Medicare nor company health plans must spend an average of fifty-six percent of their social security benefits to pay for their medical insurance premiums.[37] If they were covered by an employer-sponsored plan, they would not have to pay such burdensome premiums; they would pay only out-of-pocket costs.

These figures lead to the conclusion that the termination of an employer-sponsored retiree health plan can have a devastating impact on retirees under age sixty-five and a lesser but still significant impact on retirees aged sixty-five and older. When a company plan pays such a large percentage of health costs, its termination, especially when unexpected, has a profound impact on retirees' access to health care.

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[30] *Id.*

[31] *See Here Today, Gone Tomorrow?*, *supra* note 13, at 76; *Fair Weather Promise*, *supra* note 13, at 96. *See also infra* note 52.

[32] "Large employers, primarily, offer the continuation of health care benefits for retirees. In 1980, 84% of the participants in firms with 2500 or more employees were in health plans that continued benefits after early retirement. For firms with 100 to 250 employees, only 47% offered continuation of benefits." *Fair Weather Promise*, *supra* note 13, at 94.

[33] *Here Today, Gone Tomorrow?*, *supra* note 13, at 99.

[34] *Id.*

[35] *Fair Weather Promise*, *supra* note 13, at 94.

[36] *Id.*

[37] *Id.* at 97.

### B. *What Is To Come: Future Problems*

#### 1. Demographic and Economic Changes

The problems which current retirees have experienced with welfare benefit plans are only the tip of the iceberg. The combination of the rapid growth in the number of retirees, the rising cost of medical care, Congress' "containment" of Medicare, and the hard times in industries which support the greatest number of retirees will magnify the problem of welfare benefit termination.[38] As time passes, more employees will need assistance with medical costs, and fewer companies will be able to provide it.

The need for retiree medical insurance is growing rapidly in part because Americans are living longer and retiring earlier. In 1980, thirteen percent of the population was over sixty-five.[39] By 2005, eighteen percent of the population will be that age.[40] A person who retired in 1986 could expect to live until age eighty and thus have approximately fifteen years of retirement.[41] A person who retires in 2050 can expect to live to age eighty-five with at least twenty years of retirement.[42]

Not only are retirees living longer, but employees are retiring earlier. This trend has swelled the retiree population. Ironically, many employees who have retired early have done so at the urging of their employers or labor leaders. Employers have asked individuals to retire early to cut labor costs, and union leaders have encouraged early retirement so that workers could receive retirement benefits before employers altered their welfare plans.[43]

While the need for retiree medical insurance is growing rapidly, the costs of insurance and of medical care are skyrocketing. Health care costs have risen three times faster than the consumer price index over the last twenty years.[44] Health care premiums have tracked the increase in the cost of care, rising

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[38] *See generally Here Today, Gone Tomorrow?*, *supra* note 13, at 99.
[39] *See* 15 Pens. Rep. (BNA) No. 30, at 2067 (Dec. 15, 1986).
[40] *Id.*
[41] *See* Rabkin, *supra* note 16, at 685.
[42] *See* 15 Pens. Rep. (BNA) No. 30, at 2067 (Dec. 15, 1986).
[43] *See Here Today, Gone Tomorrow?*, *supra* note 13, at 103.
[44] *Id.* at 2, 102.

twenty-five percent a year in recent years.[45] In the last fifteen years, retiree medical costs have risen from two percent of payroll to approximately five percent.[46]

While the burden of supporting retiree benefit plans increases, companies in the industries supporting the plans are growing less profitable. In the smokestack industries — those in which retirees have extensive benefit plans won through years of collective bargaining — companies often have twice as many retirees as active workers.[47] Employers often modify or terminate retiree benefits to help keep their barely surviving companies afloat.[48]

Congress has also felt the burden of the increasing cost of retiree medical needs.[49] As a result, Congress has been "containing" Medicare since the early 1980's by making the program more efficient and by limiting coverage.[50] Congress has effectively "contained" $35 million between 1983 and 1987.[51]

Congress' "containment" of Medicare has shifted more of the cost of retiree health benefits to employers. Since most employers provide benefits as a supplement to Medicare, the less Medicare covers, the more the employer must pay to fill the gap.[52] Thus, Congress in effect has exacerbated the existing problem with employer-sponsored plans.

### 2. Changes in Recent Court Cases and in Accounting Standards

In addition to the growing burden of retiree medical benefits, recent case law developments and changes in national account-

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[45] *Id.*

[46] *Id.* One expert, however, has estimated that the average company needs to set aside three percent of the payroll in advance to fund future welfare benefit costs. *See* Wessel, *Promises, Promises: Firms Seek to Cut Insurance for Retirees*, Wall St. J., Apr. 17, 1985, at 35, col. 4.

[47] *See Here Today, Gone Tomorrow?*, *supra* note 13, at 99.

[48] *See* Vogel, *supra* note 10, at 184.

[49] *See* DEVELOPMENTS IN AGING, *supra* note 24.

[50] *Id.* at 174.

[51] *See Retiree Health Benefits*, *supra* note 17, at 106. *See generally* DEVELOPMENTS IN AGING, *supra* note 24, at 155.

[52] The most common benefit plans are "carve-out" or "supplement" plans in which the employer pays for all health care which Medicare will not cover. "Coordination of benefits" plans are also popular. Under these plans, the employer initially pays for all medical costs under certain conditions, and the beneficiary reimburses the employer for any costs Medicare eventually covers. All these types of plans are structured so that employers' share of retiree medical costs automatically increase in direct proportion to how much Medicare coverage decreases. *See Fair Weather Promise*, *supra* note 13, at 96.

ing standards also have led employers to amend or terminate their benefit plans.[53] In the last four years, courts regularly have required employers to honor their promises of retiree welfare benefits unless a benefit plan clearly gives an employer the right to amend or terminate his plan. As a result, employers have been encouraged to change the language of benefit plans and put employees on notice that the employer believes it has the option of unilaterally amending or terminating the plans.[54] These changes in the wording of benefit plans undoubtedly will both give rise to great uncertainty about the benefits to which retirees will be entitled, and will produce much litigation.

Recent changes in national accounting standards have begun to force employers and their shareholders to recognize the huge liability incurred by promising retiree health benefits. In 1984, the Financial Accounting Standards Board began to require employers to report the present value of any retirement health benefits they have promised to their employees as a footnote on their balance sheets.[55] A study made before the new accounting standards had been proposed revealed that few employers were aware of the extent of the liability they were incurring by providing retiree health benefits.[56] That study reported that seventy-nine percent of the surveyed employers who provided retiree health plans had not evaluated the aggregate costs the plans incurred.[57] It also reported that despite recent developments in the case law, eighty-one percent of those employers were unaware of legal precedents being set and believed that they had a right to amend or terminate their welfare plans unilaterally.[58]

The combination of the emerging case law in this area and the new accounting standards should encourage employers and their shareholders to take a closer look at the benefits they promise to their retirees. When the companies review the case law and the economic and demographic trends, their responses

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[53] The number of employer-sponsored health plans for retirees fell five percent between 1980 and 1984. *See Who'll Pay for Retirees' Health Plans?*, U.S. NEWS & WORLD REP., Oct. 21, 1985, at 72. *See also Fair Weather Promise*, *supra* note 13, at 105.

[54] *See* Van Olson, *supra* note 16, at 407. Employers have also been encouraged to cut off benefits immediately after plant shutdowns and during strikes so as not to encourage retirees to believe that their benefits extend beyond the termination of the employment contract. *See* Barnes & Mishkind, *supra* note 16, at 609.

[55] *See* statement of the Washington Business Group on Health in *Retiree Health Benefits*, *supra* note 17, at 157.

[56] *See id.* at 159.

[57] *Id.*

[58] *Id.*

will likely exacerbate the problem for retirees. Employers may be less willing to guarantee medical coverage of their retirees and may attempt to amend or terminate their plans in order to eliminate their current liability.[59] These changes will spur more litigation and in turn put more pressure on Congress to come up with a solution to the growing need for retiree health benefits.

Finally, the fact that most employers meet their retiree benefit obligations out of their current revenues is bound to create enormous problems in the future. Only five percent of employers promising retiree medical benefits pre-fund their plans as they incur the obligation to pay benefits in the future.[60] Thus, even those benefit plans which employers do not terminate or modify in response to new legal precedents or accounting standards are vulnerable. If an employer's revenues fall significantly or cease altogether, there will be no funds to pay for its retirement plan.[61]

## II. Remedies Under Current Law

While terminations and modifications of retiree health benefit plans escalate, the system for providing retirees with relief has proven inadequate. For most retirees who have had their benefits modified or terminated, the only recourse is to sue their former employer in federal district court.[62] Once in court, retirees bear the burden of proving that their employer has breached a contract or violated the few provisions of ERISA that apply

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[59] *See generally* Barnes & Mishkind, *supra* note 16, at 609; *see also* Rabkin, *supra* note 16, at 685.

[60] *See* statement of the Washington Business Group on Health in *Retiree Health Benefits, supra* note 17, at 158.

[61] A comparison between a company's current liabilities and its current assets makes clear the potential problem with the pay-as-you-go system. "Estimates are that for the Fortune 500 companies the unfunded liabilities for retiree health benefits approaches $2 trillion, while the total assets of these companies is only $1.3 trillion." *Here Today, Gone Tomorrow?, supra* note 13, at 2 (statement of Rep. Roybal (D-Cal.)).

[62] In one noted exception, active union workers struck their employer after it had terminated retiree benefits. The employer was forced to re-establish the plan. *See Fair Weather Promise, supra* note 13, at 108. Retirees who receive their benefits under a collective bargaining agreement may also resort to arbitration if the collective bargaining agreement provides for it. *See* Anderson v. Alpha Portland Indus., Inc., 752 F.2d 1293, 1298 (8th Cir.), *cert. denied*, 471 U.S. 1102 (1985). Retirees have been no more successful in arbitration proceedings than they have been in court. *See* Note, *Insurance Premiums for Retirees after the Union Contract Expires*, 44 Ohio St. L.J. 521, 532–33 (1983). *See also* Barnes & Mishkind, *supra* note 16, at 600.

to welfare benefits.[63] Even when retirees win a judgment of liability against a former employer, they often have to settle for a scaled-down health plan or none at all.[64]

Two questions face retirees whose employer has terminated or modified their benefit plan. The first is whether the employer had a right to do so unilaterally. An employer may alter a benefit plan that has not yet vested without retirees' consent but must obtain their consent before changing a vested plan.[65] Since retiree benefits are provided through contract, the determination of whether the benefits are vested turns on the parties' intent. In determining intent, courts must decide what evidence is relevant and what inferences can be drawn from that evidence.[66] Furthermore, courts must interpret the contract according to the Labor Management Relations Act (LMRA)[67] for union retirees and according to ERISA for at-will retirees.[68] The courts have developed two parallel bodies of common law for these two statutes which determine whether benefits are vested.[69]

The context in which a retirement benefit is promised determines which federal law will control. If the benefit is promised as part of a collective bargaining agreement, then the common law developed for section 301 of LMRA applies.[70] In contrast, the common law developed for section 502 of ERISA controls

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[63] Although unions are not the exclusive bargaining agents for retirees, concern for former members has led some unions to hire legal counsel and cover expenses for retirees who sue their former employers. At-will retirees have no similar advocate and have had to rely on class actions under Rule 23 of the Federal Rules of Civil Procedure. Despite the fact that the Secretary of Labor has authority under ERISA to sue on behalf of retirees, 29 U.S.C. § 1132(a) (1982), no Secretary has come to their aid. *See Here Today, Gone Tomorrow?*, *supra* note 13, at 56.

[64] *See infra* text accompanying notes 110–11.

[65] Vested benefits are defined as those which an employer has a contractual or statutory obligation to provide. Vested retiree welfare benefits are, in a sense, a type of executory contract. *See, e.g.*, UAW v. Yard-Man, Inc., 716 F.2d 1476, 1482 (6th Cir. 1983), *cert. denied*, 465 U.S. 1007 (1984). The employer's obligation to provide benefits, once they are vested, does not end until the retiree dies or some terminating event specified in the contract occurs. *Id.* at 1482 n.8.

[66] *See* Arizona Laborers, Teamsters and Cement Masons v. Conquer Cartage Co., 753 F.2d 1512 (9th Cir. 1985).

[67] Ch. 120, 61 Stat. 136 (1947) (codified as amended at 18 U.S.C. § 610 (1982), and at 29 U.S.C. §§ 141–197 (1982)).

[68] For purposes of this Note, "union retirees" refers to those retired individuals who receive welfare benefits through a collective bargaining agreement and who are former union members. "At-will retirees" refers to those employees who contracted individually with an employer for the promise of retirement benefits. Both ERISA and LMRA preempt state contract law. *See* 29 U.S.C. § 1144(a) (1982) (ERISA); Textile Workers Union v. Lincoln Mills, 353 U.S. 448, 456 (1957) (LMRA).

[69] *See, e.g.*, *Conquer Cartage*, *supra* note 66.

[70] *See* 29 U.S.C. § 185 (1982). Since retiree benefits are part of the agreement, this section will control. *See, e.g.*, Bower v. Bunker Hill Co., 725 F.2d 1221 (9th Cir. 1984).

claims brought by at-will employees.[71] Employers who promise retirement benefits must comply with ERISA's disclosure, reporting, and fiduciary duty standards for both union and at-will employees.[72] Courts may bar an employer who has violated these provisions from terminating or modifying his welfare benefit plan, regardless of the intent of the parties to the contract.[73]

The second question which faces retirees whose employer purports to terminate or modify their benefit plan is whether and when the courts will enforce a judgment against the employer if the retirees can prove a right to vested benefits or a substantial violation of ERISA. The answer depends on the circumstances under which the employer modified or terminated the plan. If the termination or modification was part of a bankruptcy petition, the retirees' remedy will be controlled by either section 1113 or section 365 of the Bankruptcy Code.[74] If the employer amended or terminated vested benefits as part of spinning off or closing a subsidiary, the retirees of the subsidiary generally need to prove that the parent is liable for the subsidiary's promises in order to recover from the parent.[75] If the employer has terminated or amended a vested plan as part of a general cost-cutting program, the remedies under LMRA and ERISA include both an injunction ordering the employer to reinstitute the plan and, less frequently, a damage award.[76]

The timing of the remedy has become as crucial to the outcome as the determination of the merits. It may take up to six years to get a final judgment on whether an employer must pay additional benefits. During this time, retirees are often left without medical coverage and are uncertain of whether it will ever be restored. Some retirees will die while awaiting the outcome of a lawsuit. Others will put off needed care while waiting for a result.[77]

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[71] *See* 29 U.S.C. § 1132 (1982). *See also* Central States et al. Health and Welfare Fund v. Old Sec. Life Ins. Co., 600 F.2d 671 (7th Cir. 1979).

[72] 29 U.S.C. § 1132 (1982).

[73] *See infra* note 115 and accompanying text.

[74] *See infra* text accompanying notes 132–42.

[75] Since a closed subsidiary often retains no assets, retirees usually have to sue its parent corporation. *See, e.g.*, Bower v. Bunker Hill Co., 725 F.2d 1221 (9th Cir. 1984) (order denying post-trial motions and directing entry of judgment pursuant to Rule 54(b) (No. C-82-412)) (retirees in a jury trial successfully pierced a corporate veil to hold the parent company liable).

[76] *See infra* text accompanying notes 147–50.

[77] *See* Mamula v. Satralloy, Inc., 578 F. Supp. 563, 577 (S.D. Ohio 1984).

The following description of the current remedies available to retirees is divided into two sections. The first outlines the claims and remedies available to union retirees. The second section outlines the claims and remedies available to at-will retirees. Claims under ERISA are available to both at-will and union retirees and are discussed in the at-will section.

### A. *Remedies for Union Retirees*

#### 1. Context of Provision and Termination of Benefits

In the union context, retiree welfare benefits are provided through the collective bargaining process. Retiree welfare benefits are a permissive subject of bargaining[78] under section 8(d) of the NLRA.[79] Unions and employers may renegotiate non-vested benefits included in the bargaining agreement, but they must have retirees' consent to change vested benefits.[80]

Two documents, the collective bargaining agreement (CBA) and the summary plan description (SPD), usually contain the agreement for union retiree benefits. The CBA lays out the plan in detail, while the SPD, a readable layman's version of the agreement required by ERISA,[81] outlines the fundamentals of the plan and also contains all conditions under which the employer may modify or terminate benefits.

Employers terminate or modify union retiree benefit plans most often when the collective bargaining agreement has expired or has been terminated. Such times include plant shutdowns,[82] strikes,[83] and bankruptcies.[84] Employers modify retiree benefit plans at these times because they mistakenly assume that once the underlying employment agreement expires, so does the

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[78] Allied Chemical and Alkali Workers v. Pittsburgh Plate Glass Co., 404 U.S. 157, 188 (1971).

[79] 29 U.S.C. §§ 151–169 (1982).

[80] *Pittsburgh Plate Glass Co.*, 404 U.S. at 181 n.20; *see also supra* note 65.

[81] 29 U.S.C. § 1022 (1982).

[82] *See, e.g.*, Bower v. Bunker Hill Co., No. C-82-412 (E.D. Wash., Dec. 23, 1986) (order denying Bunker Hill's post-trial motions and directing entry of judgment pursuant to Rule 54(b)).

[83] UAW v. Cadillac Malleable Iron Co., 97 Lab. Cas. (CCH) ¶ 10,031 (W.D. Mich. 1982), at 17,119–20, *aff'd*, 728 F.2d 807 (6th Cir. 1984).

[84] *See, e.g.*, Hansen v. White Farm Equip. Co., 5 Employee Benefits Cas. (BNA) 2130 (N.D. Ohio 1984).

agreement for retiree benefits. This assumption is predicated on the belief that retiree welfare benefits are not vested.

Union retirees who sue their former employer to regain their welfare benefits plan base their suits on the argument that both parties had agreed for benefits to vest at some point.[85] Once the benefits have vested, retirees argue, the employer's obligation to continue providing benefits cannot be extinguished by termination of the CBA or by a plant shutdown, because the benefits contract has an independent termination date.

### 2. Suits for Recovery of Benefits

For union retirees, judicial decisions construing section 301 of LMRA are the primary source of law for interpretation of retirement benefit agreements.[86] That section mandates that CBA's be interpreted in harmony with federal labor policy.[87] To a lesser extent, however, the case law construing ERISA also affects how the agreements are interpreted.[88] Since ERISA controls the interpretation of the terms of an SPD,[89] courts can draw inferences about how to interpret a collective bargaining agreement based on the terms that the parties have included in, or excluded from, their SPD's.

If union retirees bring suit to recover benefits under section 301 of LMRA and section 502 of ERISA, the court's primary role is to determine whether the parties intended to create a vested benefit. Since the NLRA allows the parties to contract for benefits which will survive the term of the collective bar-

[85] Some individuals who have not yet retired also have a right to vested benefits. This is the case, for example, when an employer promises that benefits will vest once an employee works a certain number of years, rather than only when she reaches retirement age. Laid off employees whose right to benefits has vested can raise the same types of claims as retirees. *See, e.g.*, Bower v. Bunker Hill Co., No. C-82-412 (E.D. Wash. 1982) (order denying Bunker Hill's post-trial motions and directing entry of judgment pursuant to Rule 54(b)).

[86] UAW v. Yard-Man, Inc., 716 F.2d 1476, 1479 (6th Cir. 1983), *cert denied*, 465 U.S. 1007 (1984). "[T]he substantive law to apply in suits under section 301(a) is federal law, which the courts must fashion from the policy of our national labor laws. . . . State law, if compatible with the purpose of section 301, may be resorted to in order to find the rule that will best effect the federal policy. . . . Any state law applied, however, will be absorbed as federal law and will not be an independent source of private rights." Textile Workers Union v. Lincoln Mills, 353 U.S. 448, 456–57 (1957). The court in *Yard-Man* relied on "traditional rules for contractual interpretation [to the extent that] . . . their application is consistent with federal labor policies." 716 F.2d at 1479.

[87] *See* Textile Workers Union v. Lincoln Mills, 353 U.S. 448 (1957).

[88] *See* 29 U.S.C. § 1132 (1982).

[89] *See infra* text accompanying notes 113–16.

gaining agreement,[90] and also allows unions to bargain for retiree welfare benefits,[91] no legal barriers prevent retirees from asserting that their benefits survived the term of the CBA. To prevail, however, they must satisfy the court that as a factual matter the parties intended to create benefits that outlast the CBA.

Unfortunately, the court's job of determining the parties' intent has not been as simple as it sounds. Often the language of the CBA is ambiguous, says nothing about vesting, or conflicts with the SPD.[92] Courts then must determine the parties' intent from the circumstances surrounding the agreement.[93] In sorting through these circumstances to determine intent, the court relies on the common law courts have developed for section 301 of the LMRA.[94]

There have been a number of significant developments in the last five years in the court decisions that address union retiree welfare benefits. First, courts have perceptibly changed their attitude towards retirees' claims. By changing the inferences derived from certain facts, courts have shifted from regularly holding for employers to regularly holding for retirees. In the older cases, courts for the most part found that if an employer in any way reserved the power to modify or terminate the plan, he could act unilaterally.[95] In contrast, the more recent cases have held that unless the evidence indicated that the employer consistently and unambiguously had reserved the right to modify or terminate the plan, the employer could not terminate or modify the plan without approval of the plan beneficiaries.[96]

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[90] *See* John Wiley & Sons v. Livingston, 376 U.S. 543, 555 (1964).

[91] *See* Allied Chemical and Alkali Workers v. Pittsburgh Plate Glass Co., 404 U.S. 157, 181–82 (1971).

[92] *See, e.g.*, Bower v. Bunker Hill Co., 725 F.2d 1221 (9th Cir. 1984).

[93] *See, e.g.*, Arizona Laborers, Teamsters and Cement Masons v. Conquer Cartage Co., 753 F.2d 1512, 1517–18 (9th Cir. 1985).

[94] *Id.* A well-developed case law has evolved for disputes between employers and active workers. Since disputes with retired workers are relatively new, the most significant cases that specifically address retiree benefits have been decided in the last five years. Hence, in actions involving both LMRA and ERISA, the courts only recently have developed case law principles unique to CBA sections governing retiree benefits. *See infra* notes 97–104 and accompanying text.

[95] *See* Rabkin, *supra* note 16, at 680–81.

[96] In almost every recent case in which the court has found benefits not to vest, there was consistent, specific language in the contract to that effect. *See* In re Erie Lackawana Ry. Co., 548 F.2d 621, 626 (6th Cir. 1977); In re Cortland, 30 Bankr. L. Rptr. 717 (N.D. Ohio 1983); UAW v. Roblin Indus., Inc., 561 F. Supp. 288 (W.D. Mich. 1983); Metal Polishers Local No. 11 v. Kurtz-Kasch, Inc., 538 F. Supp. 368 (S.D. Ohio 1982).

In general, determination of the intent of the parties from the circumstances surrounding the agreement is much like determinations of intent under state contract law. Inquiries are made into the testimony and notes of negotiators of the CBA,[97] the documents relating to the plan (including the SPD and the agreement between the employer and his insurer),[98] the testimony about the employer's own interpretation of the contract as evidenced by exit interviews and presentations to retiring workers,[99] the evidence of the employer's actions during periods when there was no collective bargaining agreement in force (such as during strikes and after contract expiration),[100] and the documents and treatment of non-union workers receiving benefits similar to those of union workers.[101]

In determining intent, the courts have also begun to employ two important inferences. The first inference is derived from the language used in the CBA and SPD. If benefits are termed "retiree benefits," and if there is either no language or only ambiguous language about whether the employer can modify or terminate the plan, then the court will infer that the parties intended benefits to continue as long as each beneficiary remained a "retiree."[102] In effect, the court has inferred from the lack of limiting provisions and the use of the word "retiree" that the benefits become vested at retirement. Courts have been careful to note that, although the status inference is persuasive, it alone cannot be the basis for a determination that the parties intended to make the benefits vest. There must be other inferences or evidence to support a determination of intent to vest.[103]

The second important inference of intent has been based on factual assumptions about the context in which retiree benefits are provided. This inference, termed the "context inference,"

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[97] *See, e.g.*, Laborers Health and Welfare Trust Fund v. Kaufman & Broad, Inc., 707 F.2d 412, 418 (9th Cir. 1983).

[98] *See, e.g.*, Bower v. Bunker Hill Co., 725 F.2d 1221, 1224 (9th Cir. 1984).

[99] *See, e.g.*, *Laborers Health and Welfare Trust Fund*, 707 F.2d at 418. *See also* Van Olson, *supra* note 16, at 407.

[100] *See, e.g.*, UAW v. Cadillac Malleable Iron Co., 728 F.2d 807, 808–09 (6th Cir. 1984).

[101] *See, e.g.*, Arizona Laborer, Teamsters and Cement Masons v. Conquer Cartage Co., 753 F.2d 1512, 1518 (9th Cir. 1985).

[102] This inference is referred to as the "status inference" because an individual's eligibility for benefits depends upon his status as a retiree. *See, e.g.*, UAW v. Yard-Man, Inc., 716 F.2d 1476, 1482 (6th Cir. 1983), *cert. denied*, 465 U.S. 1007 (1984). *See also* Rabkin, *supra* note 16, at 679; Van Olson, *supra* note 16, at 403; Vogel, *supra* note 10, at 203–05.

[103] *See Yard-Man*, 716 F.2d at 1482.

was developed and has been applied only in the union setting. Courts have assumed that union retirees do not want their retirement security to be subject to the uncertainties of collective bargaining. As a result, courts have inferred that the parties intend the benefits to vest unless the CBA provides otherwise.[104] Since by law retirees are not part of the bargaining unit and can exert no legal pressure on a union to represent them, retirees can never be certain that their benefits would be provided past the next round of CBA negotiations. This apparent lack of power has led courts to infer that the parties must have intended benefits to vest. The context inference, like the status inference, will not by itself move a court to find that benefits have vested. Retirees must produce additional evidence of an intent to vest in order to meet their burden of proof.

These two inferences have had a significant impact on how courts interpret CBAs under section 301. They have not shifted the burden of proof to the employer as would a presumption of vesting, but they have increased retirees' chances of success when the language of the contract is ambiguous or when the employer has acted in conflict with the language of the contract.

### 3. Remedies Available

The most common remedy for union retirees who have had their benefit plans modified or terminated in breach of a CBA is a permanent injunction against the employer.[105] Such an injunction would require the employer to reinstate the benefit plan and to continue to provide the retiree welfare benefits as set out in the CBA. On occasion, courts have also issued preliminary injunctions to prevent employers from modifying or terminating benefit plans during litigation.[106] Courts also infrequently award damages to retirees for emotional distress or award death benefits to the estates of retirees who died while receiving reduced benefits or no benefits because an employer had modified or

[104] *Id. See also* UAW v. Cadillac Malleable Iron Co., Inc., 97 Lab. Cas. (CCH) ¶ 10,031 (W.D. Mich. 1982); Roxbury Carpet Co. and Textile Workers of America, 23-2 Lab. Arb. Awards (CCH) ¶ 8521 (1973) (Summers, Arb.); Canter v. Berkshire Life Ins. Co., 171 Ohio St. 405, 171 N.E. 2d 518 (1960). This inference about the parties' intent appears to have little factual support. Courts could equally infer that parties to a collective bargaining usually intend non-vested benefits. Since unions and employers need flexibility in the contract terms each time they renegotiate it, it may be assumed that the parites intend to renegotiate benefits each time a contract expires.

[105] *See* Barnes & Mishkind, *supra* note 16, at 594.

[106] *Id.*

terminated its plan.[107] If the retirees bring ERISA claims[108] along with the LMRA claims, retirees may also recover court costs and attorney's fees.[109]

Since many parties settle their suits, courts often do not reach the remedy stage. Usually these settlements are for a scaled-down retiree benefit plan.[110] Two considerations encourage retirees to settle. First, the employer can appeal the decision and thereby delay the permanent restoration of the welfare benefit plan. Second, since most employers cannot afford a judgment requiring a lump sum payment to retirees,[111] as a practical matter the court can only order the employer to keep paying the benefits out of the employer's current revenues. If the employer's difficulty in meeting retiree costs motivated the original modification or termination, then it may also be in the retirees' best interest to accept a new plan which the employer can afford.

The courts' recent development of inferences favorable to retirees has given retirees a slight advantage in litigation against former employers if the CBA is ambiguous or conflicts with the SPD.[112] Yet even if retirees can win on the merits, the uncertainties and delays take a heavy toll. At most, retirees can expect to wait several years while the litigation is pending and then obtain no more—and often something less—than their original benefit plan. Because of the delay and their employer's practical inability to provide them with a lump sum payment, retirees will probably be forced into settling for less than that to which they have a legal right.

### B. *Remedies for the At-Will Retiree*

#### 1. Context of Provision and Termination of Benefits

Retirees who were employed at-will and whose retirement benefits were not part of a comprehensive written employment contract face different problems at trial than union retirees.

[107] *See id.* at 595–97.
[108] *See infra* text accompanying notes 114–18.
[109] 29 U.S.C. § 1132(g)(1) (1982).
[110] The settlement in Eardman v. Bethlehem Steel Corp. Emp. Welfare Benefit Plans, 607 F. Supp. 196 (W.D.N.Y. 1984), subsequent to the District Court's decision, is a good example of an agreement between retirees who had won a liability judgment and their former employer. *See* U.S. NEWS & WORLD REP., *supra* note 53, at 72.
[111] *See, e.g.*, Barnes & Mishkind, *supra* note 16, at 595.
[112] *See supra* text accompanying notes 102–04.

Since at-will employees are not represented by a union, no collective bargaining agreement governs their relationship with their employer. Often, the only documentation of their benefits program is found in the summary plan description required by ERISA and in any contract the employer has negotiated with an insurance carrier that underwrites the benefits plan. These materials often do not indicate that the employer has promised retirement benefits to current employees as deferred compensation. As a result, employers can more easily assert that the retirement benefits are a gratuity rather than a contractual obligation. If the benefits are found to have been a gratuity rather than compensation, employers could legally terminate the benefits unilaterally.

### 2. Suits for Recovery of Benefits under ERISA

At-will retirees attempting to recover their benefits can look only to ERISA for a legal remedy.[113] Both union and at-will employees may claim that an employer who violated the reporting and disclosure provisions of ERISA should be prevented from terminating or modifying its welfare plan.[114] Retirees can use two theories to base a claim for relief on an employer's violation of ERISA. First, they can argue that granting them relief will give operative force to ERISA's policy of requiring employers to inform employees of the extent of their benefit rights. Courts have barred employers from modifying or terminating welfare plans unilaterally when those employers have violated ERISA's reporting and disclosure requirement, even when there was no evidence that the parties intended for the employer to lose unilateral control of the plan.[115] Secondly,

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[113] Section 301 of LMRA, discussed in the previous section, applies only to benefit plans established through the collective bargaining process. State contract law, which traditionally controlled these types of plans, has been preempted by ERISA. *See supra* notes 70–71.

[114] *See, e.g.*, Policy v. Powell Pressed Steel Co., 770 F.2d 609 (6th Cir. 1985), *cert. denied*, 475 U.S. 1017 (1986).

[115] ERISA requires that the SPD inform both union and at-will retirees of any conditions under which the employer can modify or terminate the retiree benefit plan. ERISA specifically provides that "[t]he . . . summary plan description shall contain [a description of] . . . circumstances which may result in disqualification, ineligibility, or denial or loss of benefits. . . ." 29 U.S.C. § 1022(b) (1982). The judicial power to prevent employers from modifying or terminating welfare benefits when they have not unambiguously reserved the right to do so in the SPD gives ERISA some operative force. Such a remedy is not justified on the theory that the employer breached an obligation to its retirees, but rather on the theory that ERISA's reporting and disclosure require-

when employers have violated ERISA by failing to include conditions for modifying or terminating benefits in their SPD's, retirees have persuaded courts to view this failure as circumstantial evidence that the parties—the employers and their employees—did not intend to have the employer retain unilateral power to amend or terminate benefit plans.[116]

Whether or not an employer has complied with ERISA's disclosure requirements, at-will retirees may bring a claim for breach of contract if the employer modifies or terminates his benefit plan. Prior to passage of ERISA, these types of claims were controlled by state contract law.[117] Now, because ERISA preempts state contract claims for retiree welfare benefits,[118] retirees' claims are the basis of a federal law of contract interpretation governed by section 502 of ERISA.

Much of the case law construing how ERISA governs contract interpretation parallels the common law for section 301 of LMRA because union retirees have raised claims under both section 301 and ERISA in their suits.[119] Courts construing both statutes have looked to the intent of the parties to determine whether benefits have vested and have developed inferences in favor of retirees when contract language is ambiguous.

Several contract theories have been used by retirees to regain their benefits under ERISA. One contract claim is for breach of a unilateral contract. At-will retirees have argued successfully that an employer's promise of retiree welfare benefits constitutes an offer which an employee accepts if she works for the employer for a defined number of years or until retirement. Once

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ments need an effective enforcement mechanism. For mere technical violations of ERISA's standards, the court may only impose a fine rather than prevent the employer from modifying the plan. *See, e.g.*, Wolfe v. J.C. Penney Co., 710 F.2d 388 (7th Cir. 1983). However, failure to leave out a condition under which an employer can terminate a benefit plan has not been held to be such a mere technical violation. *See generally* Vogel, *supra* note 10, at 221 n.244.

[116] *See, e.g.*, Bower v. Bunker Hill Co., 725 F.2d 1221, 1224 (9th Cir. 1984).

[117] *See* Vogel, *supra* note 10, at 187–96.

[118] 29 U.S.C. § 1144(9)(a) (1982).

[119] Only one court has construed ERISA to go beyond the LMRA in protecting retiree welfare benefits. *See* Hansen v. White Farm Equipment Co., 5 Employee Benefits Cas. (BNA) 2130, 2141–42 (N.D. Ohio 1984) (held that ERISA common law required vesting of benefits when the employee retired even if the employer unambiguously reserved the right to amend or terminate a retiree benefit plan). This holding was reversed in In re White Farm Equipment Co., 788 F.2d 1186 (6th Cir. 1986). The Sixth Circuit Court of Appeals held that if Congress intended retiree medical benefits to vest when employees retired, it would have included such a provision in the vesting section of ERISA. *Id.* at 1192–93. In effect, the Court of Appeals found the bounds of the common law for ERISA to be the same as that for LMRA.

the employee accepts the offer, the employer is bound to fulfill his part of the contract. Thus, benefits effectively vest as soon as the employee meets her part of the bargain.[120]

A second contract theory under ERISA has been developed in cases that involve union retirees. According to this theory, the promise of retiree benefits is part of a bilateral contract. The employee agrees to work for a certain period of time in exchange for a wage and some deferred compensation. Retirement benefits are part of this deferred compensation. When the employer modifies or terminates those benefits, it breaches the executory bilateral contract.[121]

A less frequently raised theory is that the employer breaches its fiduciary duty as the administrator of its retiree welfare plan[122] if it modifies or terminates the plan to the detriment of retirees.[123] Although the courts have not yet reached a consensus on this issue, the trend seems to be that when an employer amends or terminates a welfare benefit plan it is acting in the role of entrepreneur or manager rather than as plan administrator.[124] Thus, an employer does not breach its fiduciary duty as plan administrator by modifying or terminating a retiree benefit plan.

At least one other plausible basis for relief under ERISA has yet to be tested in the courts. This theory adopts the doctrine of good faith and fair dealing from the state common law of contracts. When one party holds an advantage over the other, either through knowledge or through controlling the other party's performance, that party assumes a duty to disclose his special knowledge and not to use his control to hinder the disadvantaged party's performance.[125] An employer which promises benefits to its employees enjoys an advantage over them if it knows that it may alter or terminate their benefits and

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[120] *See, e.g.*, Schlosser v. Allis-Chalmers Corp., 86 Wis. 2d 226, 271 N.W.2d 879 (1978). *See also* Rabkin, *supra* note 16, at 683.

[121] *See* Note, *Pension Plans and Rights of the Retired Worker*, 70 COLUM. L. REV. 909, 917 (1970).

[122] *See generally* 29 U.S.C. §§ 1101–1114 (1982).

[123] *See* Barnes & Mishkind, *supra* note 16, at 593 n.18; Vogel, *supra* note 10, at 221–31.

[124] *See, e.g.*, United Independent Flight Officers, Inc. v. United Airlines, Inc. (UFIO-I), 756 F.2d 1262, 1268 (7th Cir. 1985); United Independent Flight Officers, Inc. v. United Airlines, Inc. (UFIO-II), 756 F.2d 1274, 1280 (7th Cir. 1985). At least one court has expressed a fear of impinging on employers' managerial prerogative. *UFIO-II*, 756 F.2d at 1280.

[125] *See generally* RESTATEMENT (SECOND) OF CONTRACTS § 161 (1981); E. FARNSWORTH, CONTRACTS §§ 4.11, 7.16 (1982).

they mistakenly believe that those benefits are vested or will vest in the future. The courts should find that an employer has assumed a duty to inform its employees fully and should be held to a standard of good faith and fair dealing. The employer who prevents an employee from fulfilling her part of a unilateral contract (i.e., by firing her just before retirement or terminating the offer just before she retires) should also be held in violation of a duty of good faith and fair dealing.

### 3. Remedies Available

The remedies available to at-will retirees under ERISA are nearly identical to those available to union retirees. The most common remedy for retirees under ERISA is an equitable remedy under section 502(a).[126] The employer can be prevented from modifying or terminating the plan or can be required by an injunction to resume the benefit plan at the level that existed before the modification or termination.[127] ERISA also provides court costs and attorney's fees to successful plaintiffs.[128] Infrequently, retirees may be awarded damages for mental distress and death benefits for those who died while the plan was modified or terminated.[129]

On a practical level, the at-will retiree is in a worse position than the union retiree. In addition to facing delays resulting from litigation, the inability of employers to meet the costs of their plans, and pressures to settle for scaled-down benefits, at-will retirees who bring suit face the problem of being unorganized. At-will retirees also do not have the same documentary evidence of their contract for benefits as union retirees. Unlike union retirees, who may raise both section 301 claims and ERISA claims, ERISA offers the only statutory remedy for at-will retirees. While union retirees may also take advantage of two inferences—the status inference[130] and the context inference[131]—at-will employees can employ only the former inference to their advantage.

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[126] *See generally* Barnes & Mishkind, *supra* note 16, at 594–98.
[127] *See, e.g.*, Eardman v. Bethlehem Steel Corp. Employee Welfare Benefit Plans, 607 F. Supp. 196, 215 (W.D.N.Y. 1984); Hillis v. Waukesha Title Co., 576 F. Supp. 1103, 1108 (E.D. Wis. 1983).
[128] *See* 29 U.S.C. § 1132(g)(1) (1982).
[129] *See generally* Barnes & Mishkind, *supra* note 16, at 596.
[130] *See supra* notes 102–03 and accompanying text.
[131] *See supra* note 104 and accompanying text.

### C. *The Obstacle of Bankruptcy*

While the federal common law of contract and the substantive requirements of ERISA determine whether the retiree is entitled to vested benefits, bankruptcy may prevent retirees from ever receiving even those benefits to which they are entitled. An employer's obligation to provide vested benefits is valuable only if that employer is able to pay for them. Bankruptcy law may relieve employers who are unable to meet their obligation to provide vested retirement benefits. Although bankruptcy law relating to retiree welfare benefits is changing rapidly, and many fundamental questions have yet to be answered, important trends have developed in the law.

In a Chapter 11 reorganization, union retirees who receive welfare benefits under a collective bargaining agreement appear to have a much better chance of regaining their benefits than do at-will retirees. Although neither the case law nor the legislative history makes clear whether this provision applies to retiree benefits, section 1113 of the Bankruptcy Code may bar employers from altering retiree benefits unilaterally.[132] That provision requires employers who file for reorganization to obtain court approval before repudiating any part of a collective bargaining agreement.[133] A court will excuse an employer from fulfilling its obligations under a CBA only after the employer has first bargained in good faith with a representative of its employees, and the two have reached a deadlock.[134] Even after an employer and its employees have reached a deadlock, a court will excuse the employer from its obligations only if the court finds that business necessity mandates such a step.[135] If section 1113 covers retiree

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[132] *See* In re Century Brass Products, Inc., 795 F.2d 265, 274 (2d Cir.), *cert. denied*, ___ U.S. ___, 107 S. Ct. 433 (1986).

[133] 11 U.S.C. § 1113(a) (1982). *See also* 3 W. COLLIER, BANKRUPTCY MANUAL ¶ 1113.01(4)(a), at 113-7 to -8 (3d ed. 1987).

[134] 11 U.S.C. § 1113(b), (c) (1982).

[135] *See id.* § 1113(c). The business necessity test is essentially a codification of the balancing test in Bildisco v. Bildisco, 465 U.S. 513, 526 (1984). Section 1113 of the Bankruptcy Code imposes a "balancing of the equities" test by which courts are to decide whether a debtor may reject a collective bargaining agreement. Among the factors to be weighed by the bankruptcy court are:

> (1) the likelihood and consequences of liquidation of the debtor absent rejection; (2) the reduced value of the creditors' claims that would follow from affirmance and the hardship that would be imposed on them; and (3) the impact of rejection on the employees. In weighing these factors, "the Bankruptcy Court must first consider not only the degree of hardship faced by each party, but also any qualitative differences."

3 W. COLLIER, *supra* note 133, ¶ 1113.01 (3d ed. 1987) (footnotes omitted).

benefits, and a judge denies an employer's petition to reject the CBA, the benefits would be treated as post-petition claims and receive administrative priority over other priority and secured claims.[136] The employer would then have to continue paying the benefits during and after the bankruptcy proceeding, just as the employer would also have to pay the wages of employees who continue to work during and after the bankruptcy proceeding.[137]

Because the inclusion of retiree welfare benefits under section 1113's protective umbrella would favor union retirees over their at-will counterparts in bankruptcy, there has been much disagreement about Congress' intent in enacting the provision. Some lawmakers tried unsuccessfully to amend section 1113 in the fall of 1986 so that the provision would specifically include retiree welfare benefits.[138] Congress did pass interim legislation to prevent employers petitioning for bankruptcy from terminating retiree welfare plans unilaterally while it considers the issue.[139]

At-will retirees do not enjoy even the hope of protection under the Bankruptcy Act that union retirees do. Since section 1113 applies only to collective bargaining agreements between unions and employers, vested retiree benefits under an at-will contract are controlled by section 365 of the Bankruptcy Code.[140] At-will retiree benefit plans have the same status as other unsecured executory contracts and will be paid only after all secured debts and priority items have been covered.[141] Only one other type of debt—subordinated loans—receives lower priority. Thus, if a company has limited assets, its retirees may never see any of their promised medical benefits.

In the case of dissolution under the Bankruptcy Code, both union and at-will retirees are in equally bad positions. Section 1113 does not apply to dissolution; therefore, retirees with

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136 *See* 11 U.S.C. § 503(b) (1982).

137 *Id.*

138 *See* H.R. 5490, 99th Cong., 2d Sess., 132 CONG. REC. H6508 (daily ed. Sept. 9, 1986).

139 *See* Pub. L. No. 99-656, § 2, 100 Stat. 3668 § 2 (1986). The prohibition of plan terminations was in effect until May 15, 1987, *see id.*, extended until September 15, 1987, and then allowed to lapse pending new legislation. *See* Pub. L. No. 100-41, 101 Stat. 309 (1987).

140 Section 365 controls executory contracts. 11 U.S.C. § 365 (1982). *See* 3 W. COLLIER, BANKRUPTCY ¶ 507.04(4), at 507-33 to -34 (15th ed. 1987).

141 *See* 11 U.S.C. § 507 (1982). *See also* In the Matter of Erie Lakawana Ry. Co., 548 F.2d 621, 630–31 (6th Cir. 1977) (no administrative priority for vested retiree welfare benefits).

vested benefits, whether union or at-will, are in the same position as at-will retirees in reorganization. Their claims will not be paid until all the secured debts and priority items are covered.[142]

Another significant factor in bankruptcy is the time it takes to complete a reorganization or insolvency proceeding. Unless section 1113 applies, an employer may terminate benefits unilaterally as soon as it files a bankruptcy petition. Benefits will not be restored until the retiree proves his claim of vested benefits, the court approves a reorganization or dissolution plan, and the priority and secured creditors are paid off. The average bankruptcy proceeding lasts three years, and a complicated case can take from six to eight years to resolve.[143]

## III. Stage I: Solutions for Current Retirees

There are two levels of problems with the current remedies. The first level of problems concerns the substance and administration of contract remedies for retiree welfare benefits. It includes flaws in the details of contract interpretation, in the enforcement of contract remedies, in the priority system in bankruptcy, in the fairness and certainty of the process, and in the timing and security of the remedies. Relatively modest changes in ERISA and the Bankruptcy Code can accomplish the important, temporary reform this area urgently needs. The second level of problems concerns the theoretical and practical implications of leaving retiree benefits to free contract. It concerns the incentive structures and booby traps that free contract creates for employers and employees in bargaining and welfare benefits.

This section of the Note summarizes the first level of problems. It also outlines Congress' attempts at solving some of these problems and explains why those attempts have failed. This discussion lays the groundwork for proposals for a modest reform of the current remedies for retirees.

The second level of problems is summarized in connection with the second stage of the proposed reform. Stage II proposes

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[142] *See* 11 U.S.C. § 507 (1982).

[143] Interview with Vern Countryman, Professor of Law, Harvard University (Jan. 20, 1987).

an entirely new system for the provision of retiree benefits, aimed at future rather than current retirees.

### A. *Summary of the Problems with Remedies Available under Current Law*

Legal remedies under LMRA and ERISA now suffer from a number of significant flaws. First, so long as the contract for retiree benefits is in any way ambiguous, the employee, the retiree, and the employer are unable to plan properly for the future. The uncertainty of whether retiree benefits vest may lead employees and retirees to hope that their benefits will be vested, while encouraging employers to hope that they may modify or terminate benefits unilaterally.[144] Contrary expectations may also lead employees and employers to take conflicting actions; employees and retirees may fail to plan for the costs of their medical insurance after retirement, and employers may fail to set aside funds to cover retirement medical benefits.

Second, even if one party asks a court to resolve ambiguity in a contract for benefits, uncertainty will remain. Litigation is an uncertain process. The outcome of cases depends on inferences and circumstantial evidence, and retiree benefits are governed by a rapidly changing body of law. During litigation, the employer does not know whether to plan on providing benefits, and the employees and retirees do not know whether to expect benefits. Congress enacted ERISA in order to eliminate just these types of uncertainties,[145] but that law has allowed ambiguities to remain in contracts for retiree benefits.

Third, even if retirees can prove that the employer is obligated by contract to provide benefits, they still may enjoy no adequate remedy. Since few employers providing welfare benefits set aside funds to cover the cost of a benefit plan,[146] the best remedy that a retiree can expect is another promise that her employer will provide benefits for life. When an employer is bankrupt, a retiree may not even get a new promise of benefits.

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[144] Of course, uncertainty could lead each one of these groups to anticipate the worst. As a result, the employee, the retiree, and the employer would over-save. Such planning is equally irrational.

[145] *See, e.g.*, S. REP. NO. 383, 93d Cong., 1st Sess., *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS 4890.

[146] Only five percent of employers who provide retiree welfare benefits pre-fund those plans. *Retiree Health Benefits*, *supra* note 17, at 158.

Fourth, LMRA and ERISA do not adequately discourage employers from modifying or terminating benefits. The employer has little to lose by terminating or modifying a benefits plan when the only cost to it is an order to reinstitute the plan in its original form.[147] At the same time, an employer has much to gain by altering its plan. The employer can use the flaws in the system of contract enforcement—such as delays due to litigation and manipulation of circumstantial evidence—to coerce retirees into settling for a less costly benefits plan.[148]

Fifth, to a certain extent, current law offers a safe harbor to employers who want to reserve the right to alter retiree benefit plans, while still allowing them to deceive their retirees and employees. Under ERISA and LMRA, employers may retain the right unilaterally to amend or terminate the benefit plan by including some language to that effect in the summary plan description and the collective bargaining agreement. At the same time, an employer who has reserved the right to alter its welfare plan can disingenuously assure its employees that although it has the right to terminate benefits, it has no intention of doing so. By holding out the illusion of retiree benefits which appear to be vested but legally are not, the employer may deceive its employees, especially those who have not read their SPD or CBA.

Sixth, the present system also effectively requires active employees to support their company's current retirees with little certainty that they themselves will receive similar benefits. Current workers bear the cost of retiree benefit plans because most employers have not pre-funded their promises. Retiree benefits are traditionally accounted for as a cost of labor and paid out of current revenues.[149] If retirees obtain a judgment against their employer, the wages of active employees can be frozen or driven down because the retirees take a larger portion of the firm's labor budget.[150]

Finally, the courts have rewarded employers who have not pre-funded their benefit plans. In many cases, judges have either

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[147] Damage remedies are only infrequently granted. *See* Barnes & Mishkind, *supra* note 16, at 596.

[148] *See supra* notes 110–11 and accompanying text.

[149] *See* Kurtz-Kasch, Inc. and Metal Polishers, Buffers, Platers and Allied Workers International Union, 79-1 Lab. Arb. Awards (CCH) ¶ 8109, at 3462 (1978) (Chapman, Arb.).

[150] *See Here Today, Gone Tomorrow?*, *supra* note 13, at 55 (union representative's comments on the impact of the costs of retiree benefits on bargaining for higher wages).

encouraged settlement or awarded retirees something less than a lump sum remedy for the very reason that employers had not already set up a fund to meet the cost of benefits. As a practical matter, without a large sum set aside for the benefits, the most a court can order is a new promise that benefits will be paid out of current revenues. Since employers' lack of funds has forced retirees to settle for either the same level of benefits or for something less than what they had been promised, employers are less likely to pre-fund their benefits.

### B. *Congress' Attempts to Solve the Problems*

Over the last several years Congress has made a number of attempts to address the problems of retirees who have had their benefits terminated or modified. Bills to amend NLRA,[151] ERISA,[152] and the Bankruptcy Code[153] have been introduced. Congress has considered direct aid programs, mandatory employer programs, federal pilot programs, and state controlled programs, all aimed at developing better health care for the elderly.[154] With the exception of one stop-gap proposal in the bankruptcy context,[155] none of the proposals has passed either house of Congress.

These proposals have failed largely because of their piecemeal nature. Although Congress has recognized the colossal problem posed by the termination of employer-sponsored retiree welfare benefits, its approach has been fragmented; the legislation introduced has been aimed at putting out short-term political fires. Lawmakers have failed to develop and propose a comprehensive legislative solution to the problem of terminated retiree health benefits.

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[151] *See, e.g.*, H.R. 309, 99th Cong., 1st Sess., 131 CONG. REC. H102 (daily ed. Jan. 7, 1985) (introduced by Rep. Conte (R-Mass.) to make retiree benefits a mandatory subject of bargaining).

[152] *See, e.g.*, H.R. 5575, 99th Cong., 2d Sess., 132 CONG. REC. H8146 (daily ed. Sept. 23, 1986) (introduced by Rep. Rowland (R-Conn.) to amend Title I of ERISA and declare that, unless otherwise specified, health and welfare benefits promised to retirees are provided for the life of the retiree).

[153] *See, e.g.*, H.R. 5490, 99th Cong., 2d Sess., 132 CONG. REC. H6508 (daily ed. Sept. 9, 1986) (introduced by Rep. Rodino (D-N.J.) to provide explicitly that section 1113 applies to collective bargaining agreements by debtors in bankruptcy).

[154] *See* 13 Pens. Rep. (BNA) No. 47, at 1971 (Nov. 24, 1986). *See also* AMERICAN ASSOCIATION OF RETIRED PERSONS NEWS BULLETIN, Feb. 1987, at 10.

[155] *See supra* note 139 and accompanying text.

The proposals have also failed because Congress has not recognized the many dimensions of the problem, including the relationship to other legislation affecting the elderly. While one congressional committee was holding hearings on the termination of retiree benefit plans, another committee was hearing testimony on the further "containment" of Medicare. Despite the crucial relationship between these subjects, Congress did not coordinate the two proceedings.[156] At a time when employers seemed increasingly less likely to provide retiree medical benefits, Congress cut back a critical new program of individual retirement savings intended to cover the costs of medical insurance for retirees.[157]

### C. *A New Analysis Aimed at a Comprehensive Solution*

At the outset it should be noted that an expansion of Medicare or Social Security to cover all of the health costs of all retirees does not appear to be politically viable, though it would be one relatively simple solution to the problems of both present and future retirees. A significant expansion of the program now seems very unlikely because Congress has already cut back on the original promises of Medicare, and the "containment" of the program has strong support in Congress.[158] Thus, realistic solutions to the retiree benefit problem must be oriented towards creating or restoring employer-sponsored plans or individual savings rather than a program of government largess.[159]

A comprehensive solution must include all individuals who are without retirement medical benefits. Yet, aside from a radical expansion of Social Security or Medicare, no one solution is optimal for all of these individuals. For this reason, individuals without retirement benefits need to be divided into a number of different beneficiary groups, with each group receiving benefits in different forms or from different sources.

First, beneficiaries should be divided into present retirees and future retirees. Future retirees (i.e., current employees) pose an

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[156] *See Retiree Health Benefits*, *supra* note 17, at 106.

[157] For a discussion of the Voluntary Employee Benefit Association (VEBA) cutbacks, see Barnes & Mishkind, *supra* note 16, at 610–11; *Retiree Health Benefits*, *supra* note 17, at 45, 75. For information on IRA cutbacks, see *Here Today, Gone Tomorrow?*, *supra* note 13, at 61–62.

[158] *See generally* DEVELOPMENTS IN AGING, *supra* note 24.

[159] *See id.* at 221.

entirely different problem than present retirees because their solution is not bound by promises made under the existing free contract system. For future retirees, Congress can design a completely new system beginning with the determination as to the best form of "contract" suitable for health benefits.

Congress should divide present retirees into those whose benefits have been terminated or modified by their employer and those who have never been promised benefits. Those who have never been promised benefits cannot gain from a change in the law controlling employer-sponsored plans. The solution to their problem, though less politically viable than amendments to ERISA and LMRA, lies in some form of direct government aid.

Present retirees whose employer-sponsored benefits have been terminated or modified should be subdivided into those who are eligible for Medicare and those who are not. Early retirees ineligible for Medicare whose benefits have been terminated often are left without any medical coverage. Many of these early retirees cannot afford to buy their own insurance.[160] Retirees who are eligible for Medicare and whose benefits have been terminated present a different issue: need Congress provide additional aid to Medicare eligible retirees just because the retirees' expectations of having more coverage has been defeated?[161]

Congress should also distinguish between those retirees' employers who terminated benefits because of bankruptcy or severe financial problems, and those who were merely pursuing a cost cutting process primarily to preserve or strengthen profits. This distinction aids in deciding who shall provide the remedy.

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[160] Insurance may cost more than half of the average social security check. *See supra* note 37 and accompanying text.

[161] Though most of the solutions in this section focus on changing contract remedies, there is one group of retirees whose need for direct government aid is particularly acute. Early retirees—those ineligible for Medicare—are left with no benefits after termination of their employer-sponsored plan. Many of these individuals were encouraged to retire early by their union or their employer as part of cut-backs in labor costs or plant closures, or for various other reasons. They had not planned for an early retirement nor had they suspected that their benefits would be terminated. This group of retirees has a particularly appealing claim for direct government aid even in light of Congress' desire to "contain" Medicare.

Less justification exists for providing direct aid to Medicare-eligible retirees who have had their claims of benefits legally extinguished. Since this group is in the same situation as other retirees who have never had a promise of benefits, financial need, rather than frustrated expectation, is a better test for determining priority in receiving government aid. Although this group has been misled by their employers and may have suffered some anxiety during the court proceedings, those retirees who had never been promised benefits may have suffered equal or worse hardships.

In the bankruptcy or financial distress situation, Congress will have to decide whether retirees should be given priority over other creditors. In the cost cutting situation, Congress may only have to insure that the legal mechanism exists for the retiree to enforce valid employer obligations.

Fundamental to this proposed two stage solution is that the remedy to each situation must grow out of the extent and nature of the promise the employer has made or is permitted to make to its retirees. Some employers may have legitimately reserved their right to modify or terminate a benefit program. It would be unfair to those employers, for instance, if Congress were to require all existing welfare benefit plans to become vested. As a result of this basic conception of fairness, the proposed changes for present retirees are premised on the contract between an employer and its employees.

For future retirees Congress has a wider choice of remedies. Since Congress will be determining the kind of promise that an employer is allowed to make to its retirees, Congress may also determine the punishment imposed on the employer who breaches that promise. The proposal for future retirees attempts to accommodate both the employees' need for security and the employers' need for flexibility by going beyond the present system of free contract.

### D. *Changing Contract Remedies*

The legislative solution for retirees who have had their vested retirement benefits modified or terminated by their employer should focus on providing them with a quick and costless way to recoup their benefits. Such a solution would combine procedural and substantive mechanisms which would make litigation over these issues easier for retirees.

Several changes in the current remedies under LMRA and ERISA could provide retirees with more certain and more rapid solutions to their problems. First, the current status inference under LMRA and ERISA could be made a presumption.[162] That is, unless an employer had unambiguously reserved the right to amend or terminate its plan by both the language in the contract

[162] Before the passage of ERISA many courts had developed a common law presumption of vesting for pensions. *See, e.g.*, Hurd v. Hutnik, 419 F. Supp. 630, 655 (D.N.J. 1976). *See also* Vogel, *supra* note 10, at 190–96.

and its subsequent actions, the benefits would be presumed vested. Once retirees had proven that their contract was ambiguous as to vesting, a court would place the burden of proof on their employer to prove, from the circumstances surrounding the contract, that the parties intended to create non-vesting benefits. If the employer was either unable or unwilling to produce evidence that the benefits had not vested, a court could grant summary judgment to the retirees.

This presumption would enable retirees to avoid the time and expense of collecting the evidence presently needed to overcome their burden of proof. The presumption may also discourage employers from modifying or terminating plans as a tactic to force retirees to settle for something less than originally promised.

Second, Congress should create a presumption in favor of a preliminary injunction against employers who unilaterally modify or terminate an ambiguously worded contract. Retirees would have to submit to the court some minimal amount of evidence that the language of the contract was ambiguous or that the employer's acts were inconsistent with the contract before such an injunction would be available. To fend off the preliminary injunction, the employer would have to show some exceptional hardship resulting from the continuation of the benefits plan during the litigation. The usual considerations of likelihood of success on the merits, likelihood of irreparable harm, impact on the public interest, and possibility of substantial harm to others[163] would be considered as part of the retirees' motion but would not be as strictly applied.

This presumption in favor of a preliminary injunction would discourage employers from terminating benefits just for the purpose of coercing retirees to settle for something less. It could also prevent retirees from putting off needed medical treatment during the trial.

Third, Congress should amend ERISA to create civil and/or criminal penalties for employers who unilaterally modify or terminate a benefit plan in breach of contract, thereby providing an additional deterrent to employers who wish to terminate or modify benefits just to force retirees to settle. Employers who face a criminal or civil penalty, or both, for terminating or

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[163] *See generally* Musto v. American Gen. Corp., 615 F. Supp. 1483, 1494 (M.D. Tenn. 1985).

modifying a benefit plan in breach of their contract would be less likely to take advantage of an ambiguous contract. Employers who wished to clarify their rights under the contract before terminating the plan could petition a federal district court for a declaratory judgment.

Several changes in the Bankruptcy Act should also be considered as part of a modest program designed to restore terminated or modified benefit plans. Since the distribution of assets in bankruptcy is a zero-sum process, giving a higher priority to retirees means giving a lower priority to other creditors. The wisdom of giving retirees a greater priority will depend upon Congress' perception of their needs relative to those of other creditors.

Congress should at least clarify whether section 1113 of Chapter 11 of the Bankruptcy Act applies to retiree benefits. On both a practical and theoretical level, Congress could justify including retiree benefits under the definition of collective bargaining agreements for the purpose of section 1113. Section 1113 protections prevent the employer from placing too much of the burden of reorganization on the workers, while also preventing the workers from striking a company while it is reorganizing. Including retiree benefits under the umbrella of section 1113 would further this goal because those benefits are as much an obligation to active workers as they are to retired workers. Vested benefits are a form of deferred compensation. To cut off such benefits would be, in effect, to lower the wages of active workers.

Non-vested benefits could also be covered by section 1113. They are an important incentive to active workers to continue working. Although active workers have no legal claim to non-vested benefits, the benefits are something for which active employees bargained something else away. Since active workers perceive themselves as future beneficiaries of plans, the hopes of obtaining even non-vested benefits should be an incentive to continue working.[164]

Congress should also consider including retiree benefits under the definition of "employee benefit plans" in section 704(a)(4) of Chapter 11. By including benefits under this section, Congress

[164] If Congress chooses to include retiree benefits under section 1113, it will be giving retirees who receive benefits under a CBA administrative priority in the case of reorganization. In doing this, Congress would also need to decide the closely related question of whether at-will retirees should receive administrative priority as well.

would be putting welfare benefits on par with pensions in both reorganization and dissolution proceedings.

## IV. Stage II: A New Program for Future Retirees

### A. *Problems with Free Contract*

This section of the Note explores the problems with leaving the provision of retiree benefits to free contract. It describes the incentive structures and booby traps that are inherent in a free contract system of retiree welfare benefits. This section highlights the need for a new system under which these benefits can be provided. This system, whether it be one of regulated contract similar to ERISA or mandatory contribution similar to Social Security, must allow employees to know with greater certainty what health benefits they will enjoy when they retire.

Free contract allows severe problems to be built into retiree benefit plans, encourages employers to breach plans, and often prevents retirees from obtaining an adequate remedy. Plans devised through free contract often are flawed at creation because they are based on two variables which neither employers nor employees can predict accurately: the cost of the medical needs of employees when they retire and the future financial condition of the company. In addition, plans are usually structured in a short-sighted way. Most plans expose employers to huge increases in costs as the cost of medical care rises and as retirees live longer.[165] Despite the uncertainty of this kind of commitment, employers usually do not set aside funds for the unknown medical expenses that current employees will incur after they retire. Instead, most employers wait until employees retire and then treat retirees' medical costs as a current expense.[166] By paying for their health plans as current expenses, employers fail to cushion themselves against the increased costs of these plans

[165] *See* Developments in Aging, *supra* note 24, at 221; *see also supra* note 52.

[166] Rather than use such pay-as-you-go systems, employers who commit themselves to pay health benefits to their employees after the employees retire could prepare in advance to meet those commitments. Employers could fund their retiree benefit plans as soon as they incur the liability by setting aside funds to cover future health costs when they make the promise of future benefits. As an alternative, employers could use a lump-sum system whereby they set aside at the employee's retirement, the present value of all benefits due to that retiree. *See Fair Weather Promise*, *supra* note 13, at 109–11.

resulting from cutbacks in Medicare or technological leaps in medical care.[167] At the same time, the pay-as-you-go system exposes the employee to the danger of losing her benefits if the employer folds or declares bankruptcy.[168] As a result, the free contract system has allowed the employer to promise benefits it may not be able to provide. Also, many employees will assume that promised retirement benefits are guaranteed, when in fact their legally vested rights may, nonetheless, prove to be illusory.[169]

The free contract system also fails to provide an adequate disincentive to prevent employers from breaching their promises of vested benefits. The economic incentives produced by using free contract to control retiree benefits make the system of benefits inherently insecure. From the employer's point of view, it is economically wise to breach a contract if it is less expensive to breach than to fulfill it.[170] In the retiree benefit context, if the costs of terminating or modifying the plan are less than the present value of the future payments due to retirees, the employer has a strong incentive to terminate or modify the plan. Since the highest cost that an employer will have to pay if it breaches a contract for benefits is the cost of continuing the plan,[171] the employer has no strong disincentive to breach the

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[167] Changes in medical technology can substantially increase the cost of medical care. For instance, CAT scans are now routinely used to examine spinal injuries while twenty years ago only X-rays would be taken. No doubt, the quality of care for spinal injuries has increased enormously with the use of CAT scans. Yet the cost of care of these injuries has increased proportionately.

In addition, because most plans simply pick up costs which Medicare does not, as Medicare is "contained" by Congress, employers' costs rise accordingly. *See Here Today, Gone Tomorrow?*, *supra* note 13, at 103. *See also supra* note 52.

[168] Since such a system requires that the employer use current revenues to cover the costs of retiree welfare plans, when the current revenues cannot meet the cost of the retiree benefit plan the employer is faced with the choice of either breaching the contract for benefits or confronting a financial crisis. *See Fair Weather Promise*, *supra* note 13, at 109–11.

[169] The free market proponent would argue that if an employee knew her employer ultimately might not provide promised retirement benefits to her, she would plan accordingly. This free market theory rests, of course, on assumptions of perfect knowledge and that all employees are rational decision makers. These assumptions have proven to be unrealistic.

[170] There are some instances in which an employer is willing to absorb the greater economic cost of fulfilling the contract. This is the case when the employer wishes to avoid the harm to its reputation that would be caused by breaching a contract. However, when the cost of not breaching is the payment of a multi-million dollar benefits plan, the employer's reputation would probably be of less concern. The LTV bankruptcy is a case in point. *See supra* note 13.

[171] The cost to the employer of losing a contract suit against its retirees is the cost of attorney's fees and the cost of the original promise. Other damages are rarely awarded. *See supra* note 147.

contract. Knowing that its liability will grow over time and that retirees often settle for less than the full benefit promised,[172] the employer has an incentive to breach even if it knows it will ultimately lose on the merits.

Employees' tendency to assume that they will receive promised benefits, combined with the legal system's failure to discourage employers from breaching their promises, puts the government at risk of having to support large numbers of retirees who could have provided benefits for themselves. Some of those retirees who have lost their benefits could have saved for their own medical insurance had they known the employer- sponsored plan would be terminated. Instead, these individuals will be forced to look to the government for aid.[173] Congress can relieve itself of much of this burden, and also spare future retirees some of the uncertainty that current retirees face, by regulating employers' commitments to provide retirement benefits. Congress recognized a similar need in the early 1970's by passing ERISA for pensions.[174]

In solving the medical benefits problem of future retirees, the primary question before Congress is how far the new system should deviate from a free contract system. In other words, to what extent should the contract between employers and employees for retirement health benefits be regulated?

## B. *Basic Requirements for a New Program*

### 1. Policy Goals

Any program designed to meet the needs of future retirees must meet certain minimum policy goals. First, the program must assure that the promises made to individuals when they are active employees will be met when those individuals retire. Benefits promised one day should not depend on the company's financial condition thirty years later.

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[172] *See supra* notes 105–09 & 147 and accompanying text.

[173] While the government theoretically could respond to this problem simply by informing retirees that they should not have relied on the retirement benefits their employers have promised, the government would be more likely to pay for retirees' health care needs by expanding the Medicare system.

[174] *See* H.R. REP. No. 533, 93d Cong., 1st Sess., *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS 4639, 4643; S. REP. No. 127, 93d Cong., 1st Sess., *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS 4838.

Second, the program should encourage employers to pay for health care costs that employees might otherwise have to bear directly or that might fall to the government. To be politically viable, the program should do so with only a minimum amount of government contribution.

Third, the new program must not overburden employers. An employer's obligation to provide retiree welfare benefits must reflect the employer's ability to pay. The new system must also allow the employer some flexibility so that the employer can meet downturns in the economy and stiff competition.

Fourth, the new program should allow benefit plans to adapt to changes in medical technology and to unexpected changes in demography. Such flexibility is necessary for the program to survive for more than one generation.

Fifth, the program should allow the benefits to be portable. That is, employees ought to be able to move from employer to employer without jeopardizing the benefits that they have accrued.

### 2. Fundamental Political Constraints

A new program for retiree welfare benefits must also work within a number of political constraints. A significant expansion of Medicare or Social Security which would include a promise to cover the health care costs of individuals who will not retire for thirty years does not seem to be politically viable.[175] Congress' "containment" of Medicare and the hard-fought battles over the Social Security program attest to the unlikelihood of a new or expanded direct aid program for the elderly.

The political forces against creating an additional tax expenditure program for the elderly are also formidable. The Deficit Reduction Act of 1984 (DEFRA)[176] and the Tax Reform Act of 1986[177] focused on reducing tax expenditures as the primary vehicle with which to reduce taxes.[178] However, this general opposition to creating additional tax expenditure programs for

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[175] *See supra* text accompanying notes 158–59.

[176] Pub. L. No. 98-369, 98 Stat. 494 (1984) (codified as amended at 26 U.S.C. §§ 1-9504 (1982 & Supp. 1985)).

[177] Pub. L. No. 99-509, 100 Stat. 1951, 1964, 1965, 1995 (1986) (codified as amended in scattered sections of 26 U.S.C.).

[178] One of Congress' recent attempts at creating better retiree health care through a tax expenditure, the Voluntary Employee Benefit Association (VEBA), was eliminated as a result of DEFRA. *See Retiree Health Benefits*, *supra* note 17, at 1.

the elderly may be overcome if a new program is able to decrease significantly the costs of Medicare by substituting employer-funded benefits.

Proposals for a new program for retiree medical benefits will also have to cope with a strong employer lobby. Struggling smokestack industries interested in limiting their retiree benefit programs for future retirees will resist new restrictions on their ability to modify or terminate benefits. Fortunately, a new tax expenditure program may overcome some of this opposition if it includes means for employers to escape their burdens in the most desperate situations.

A more specific though no less important political constraint for a new program is that it be voluntary. Although such a constraint may not be in the best interest of retirees, it seems to be a threshold condition for any new program for employer-sponsored retiree health benefits.[179] It is difficult to imagine that Congress would create a mandatory program for health benefits while leaving the pension program voluntary.[180]

A comprehensive proposal for retiree welfare benefits will also have to compete for tax dollars with other important programs for the elderly. At present, Congress is considering a number of related programs including Medicare coverage of catastrophic illness, state risk pools to provide temporary insurance for the uninsured and uninsurable, state innovations with loan guarantees, and public education about the costs of retirement health care.[181] Many of these programs are oriented towards individuals who are currently uninsured and in need.

### 3. Economic Constraints

A new program for retiree welfare benefits is also bound by the economic constraints on employers, employees, and government. The primary economic question for Congress is who is best able to bear the rising costs of retirees' medical care. Once Congress has allocated the cost of retiree health among

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[179] Congress has regularly looked to voluntary programs to solve retired people's need for income. ERISA, individual retirement accounts, and voluntary employee benefit associations are cases in point. *See supra* notes 1–9 and accompanying text (ERISA); *infra* notes 211–12 and accompanying text (VEBAs); *infra* notes 214–15 and accompanying text (IRAs).

[180] Congress has already shown its preference for retirement income security over the employer-sponsored retirement medical benefits security by the passage of ERISA in 1974. *See supra* note 9.

[181] *See* 13 Pens. Rep. (BNA) No. 47, at 1971 (Nov. 24, 1986).

the government, the individual, and the employer, Congress must then decide the conditions under which those costs may be shifted from one group to another.[182]

The health care expenses of retired employees do not depend on the number of persons currently on an employer's payroll or on an employer's current level of production. At the present time, however, those employers who provide benefits treat retirees as if they were a current operating expense that rises and falls with an employer's level of economic activity.[183] Retiree welfare benefits are treated as part of the package of wages and benefits which employers provide to their present and former employees.[184] Employers have treated these benefits in such a manner because most of them have assumed that such benefits are no more difficult to terminate than employee wages.

If Congress is to place an immovable burden of retiree welfare benefits on employers, one that makes retiree benefits a fixed cost of production and that does not depend upon employers' levels of economic activity, then employers may be placed in a financially precarious position. Such an additional fixed cost of production would inhibit the ability of employers to adapt either to downswings in the economy or to stiffer competition.[185]

On the other hand, if employers recognized retiree welfare benefit costs as fixed and not tied to production, they might be more willing to set aside funds to pay those costs in the future. In addition, employers are more likely to continue production when revenues are dropping if retiree benefits are treated as fixed rather than variable costs.[186] Once the benefits become a fixed cost of production, moreover, Congress could require pre-

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[182] For instance, Congress must decide whether the employer should be allowed to shift its portion of the costs of retirement benefits to the government or to the individual retiree. Congress must also decide under what conditions such shifting would be allowed.

[183] *See* Kurtz-Kasch, Inc. and Metal Polishers, Buffers, Platers and Allied Workers International Union, 79-1 Lab. Arb. Awards (CCH) ¶ 8109, at 3459, 3462–63 (1978) (Chapman, Arb.).

[184] *Id.*

[185] Of course, the employer's ability to adapt will depend in part on the elasticity of demand for the employer's product and the willingness of employees to work for lower wages. The employer could be able to pass the entire cost of retiree welfare benefits on to the consumer or employees may take a cut in wages to meet economic downturns or stiff competition. In either of these cases, benefits may remain fixed and the employer will be able to adapt to a changing economic climate.

[186] It is fundamental microeconomic theory that an employer will keep producing so long as current revenues cover variable costs. If retiree benefits are treated as a fixed cost, then variable costs will be all the lower and thus easier to cover with current revenues.

funding without a significant impact on most employers.[187] A pre-funding requirement would add even greater security to retiree welfare plans than would merely making them a fixed cost of production.

### C. *Models for a New Program*

A number of current government programs can be used as models for creating a more secure system of retiree welfare benefits. These programs either shift costs from the government and the individual to the employer, or encourage employers to provide compensation in a form other than wages. This shift is achieved in a number of ways, which include providing tax incentives to the employer (e.g., the ERISA model), developing the economic power of the employee (e.g., the bargaining model), granting a neutral party the power to enforce "fair" cost shifting (e.g., the arbitration model), or mandating that the employer provide compensation in a form other than wages (e.g., the Social Security model). All of these models except the last one are voluntary in nature. None of these models, however, provide the ideal solution to the problem because none of them reach the proper economic and political balance between the need of retirees to have a secure and predictable system of benefits and the need of employers to have some flexibility in their costs of production.

#### 1. ERISA

Amending ERISA to protect retiree welfare benefits in the same way that it protects pensions provides the most convenient solution to the retiree health care problem. Such a solution has already drawn support in Congress and among academics.[188] If this approach were adopted, retiree health programs would be voluntary. Further, once the program was created and the employer had availed itself of the tax benefits, the retiree welfare benefits could be required to vest within a fixed number of years. The plan would be pre-funded[189] and would meet the adminis-

[187] *See generally Here Today, Gone Tomorrow?*, *supra* note 13, at 48.
[188] *See id.* at 106. *See also* Vogel, *supra* note 10, at 234–36.
[189] *See* 29 U.S.C. § 1082 (1982).

trative standards of ERISA, including the fiduciary duty[190] and reporting and disclosure standards[191] imposed by ERISA. Finally, welfare benefit plans would be bound by ERISA's requirements for termination.[192] The employer could not unilaterally amend or terminate vested benefits. Benefits would be insured by the Pension Benefit Guarantee Corporation (PBGC).[193] Of course, Congress could modify this plan by picking and choosing which of ERISA's provisions would apply to welfare benefits.

The primary problem with incorporating welfare benefits into ERISA is that it would multiply the existing problems with qualified pension plans. Already there is fear that the PBGC is not economically sound.[194] ERISA also has a number of unsolved portability problems. In addition, some legislators fear that placing ERISA-type restrictions on welfare plans would hasten employer cancellation of such plans. Finally, retirees would also have to look to the courts to enforce their contract. Thus, their remedies under ERISA would be subject to many of the same defects from which they presently suffer.

### 2. Bargaining

A second model, the regulated bargaining model as envisioned in the NLRA and LMRA, creates a framework in which employees and their employers can bargain fairly for wages and working conditions. Remedies are provided under NLRA and LMRA to employees or employers who have been subject to unfair tactics in organizing or bargaining. At present, however, retirees have no rights under the NLRA to bargain with their former employers.[195] The Supreme Court has found that retirees do not have a community of interest with active employees and

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[190] *See id.* §§ 1101–1114.

[191] *See id.* §§ 1021–1031.

[192] *See id.* §§ 1341–1348.

[193] The Pension Benefit Guarantee Corporation was established to insure employees against the loss of pension benefits resulting from plan terminations. The PBGC is directed by the government and funded jointly by the government and private employers. *See* S. REP. No. 383, 93d Cong., 1st Sess., *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS 4890.

[194] *See Retiree Health Benefits*, *supra* note 17, at 52.

[195] *See* 29 U.S.C. § 152(3) (1982). The Supreme Court in Allied Chemical and Alkali Workers v. Pittsburgh Plate Glass Co., 404 U.S. 157, 173 (1971), excluded retirees from the definition of "employee" in section 2(3) of the NLRA.

therefore has excluded retirees from bargaining units.[196] Thus, unions may not act as retirees' exclusive bargaining representatives and unions owe no duty of fair representation to their retirees.[197]

Despite the legal exclusion of retirees from their former unions, close ties often exist between the union and its retirees. Unions regularly bargain for the benefit of their retirees.[198] Unions also lobby Congress on behalf of their retirees,[199] fund social research of problems affecting retirees,[200] and affiliate with retiree organizations. Retiree organizations often have a strong voice in union policy,[201] and are active in grass roots organizing for the union and in campaigning for political causes.[202]

As a result of this extra-legal relationship between retirees and their former unions, retirees have fared well when the union bargaining power is strong. Unions have been able to increase pensions and benefits through the collective bargaining process even though retirees are not legally part of the bargaining unit. Unions have also effectively lobbied for increases in government assistance for their retirees.

Formally including retirees in the bargaining unit, however, could subject retirees to a system even less secure and predictable than the present one while offering no compensating advantages in return. The bargaining model in NLRA and LMRA allows for important flexibility for both the employer and the union, but it often does not provide for legally enforceable security. Retiree benefits, if treated as a bargaining subject similar to wages, would be vulnerable in future negotiations. With

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[196] The Court found that retirees were not an appropriate group to include in the bargaining unit because they would exert all of their influence on only a few issues. *Pittsburgh Plate Glass Co.*, 404 U.S. at 173. The Court feared that retirees would thus become a divisive force in collective bargaining. *See generally* Note, *Retirees in the Collective Bargaining Process: A Critical Review of* Pittsburgh Plate Glass Co. v. NLRB, 23 STAN. L. REV. 519, 537 (1971); *Recent Cases*, 39 U. CIN. L. REV. 573 (1970).

[197] *See* Schneider Moving and Storage Co. v. Robbins, 466 U.S. 364, 375 - 76 (1984).

[198] Unions have a long history of bargaining for pensions and retiree welfare benefits which directly affect retired former members. *See, e.g.*, PRESIDENT'S REP. TO THE 27TH CONSTITUTIONAL CONVENTION OF THE UAW 144 (May 15–20, 1983); PRESIDENT'S REP. TO THE 28TH CONSTITUTIONAL CONVENTION OF THE UAW 118 (June 1–6, 1986).

[199] Unions are some of the major supporters of Social Security and Medicare. *See* PRESIDENT'S REP. TO THE 27TH CONSTITUTIONAL CONVENTION OF THE UAW 148 (May 15–20, 1983).

[200] *Id.* at 150.

[201] *See, e.g.*, AFL-CIO News, Apr. 7, 1984, at 2, col. 1.

[202] *Id.*

respect to retirees, unions might be able to create as well as terminate provisions free from all constraints except the duty of fair representation.[203] Retirees' bargaining power would be dependent on active workers' willingness to strike. In a crisis situation, active workers' desires may conflict with the desires of retirees, creating a conflict of interest within the union. In this case, the duty of fair representation would be all that retirees had upon which to rely.

Including retirees in the bargaining unit would also subject retirees to the current problems with NLRA and LMRA. The system of remedies for violations of these statutes has been criticized as ineffective.[204] Retirees already have one of the most effective remedies that the LMRA provides—a cause of action for breach of contract under section 301—and it has proven wanting.[205] Finally, this model would be ineffective for retirees in units with little or no bargaining power and retirees who are unable (or unwilling) to organize. The former would lack the power to protect their interests in the event of a plant shutdown or legal CBA termination, while the latter would not benefit from inclusion in the NLRA and LMRA framework.

### 3. Arbitration

A third model through which retirees could receive benefits is a variation on the bargaining model. Congress could enact legislation which would require employers to arbitrate with retirees any changes in a retiree health plan. The plan could originate under a collective bargaining agreement or under an at-will contract. If the employer wished to change the plan for past or future retirees, it would have to enter into mandatory arbitration with a representative of the retirees and a representative of the active employees. If arbitration was unsuccessful any party could appeal the decision to a federal court.

The primary difference between the arbitration model presented here and the bargaining model is that in the arbitration context a neutral expert (and a federal judge if necessary) would balance the needs of the employer against the needs of the

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[203] *See* 29 U.S.C. § 159 (1982). The duty of fair representation attaches to a representative designated or selected for the purpose of collective bargaining under the LMRA.

[204] *See generally* Weiler, *Striking a New Balance*, 98 HARV. L. REV. 631 (1985); Weiler, *Promises To Keep*, 96 HARV. L. REV. 1 (1983).

[205] *See supra* note 147 and accompanying text.

retirees.[206] The expert would determine as a matter of equity[207] what level of benefits would be suitable for both parties.[208] With this arbitration model, employers would be more likely to find their liability limited in crisis situations. Retirees could be assured of receiving full benefits until a crisis arose. Once in a crisis, retirees would get at least as fair an outcome as they would under a pure bargaining model or as they are getting under settlements of current court cases.

This arbitration model provides less flexibility to the employer but more security to the retiree. The employer may not make unilateral changes without submitting them to arbitration. The union retiree is not at the mercy of the economic power of the active employees and the at-will retiree has some assurance that a fair result will be reached.

The primary problem with this model is that the arbitrator's decision is no more enforceable than are court decisions if the employer has no funds to continue the retiree welfare benefit plan. While this system is more effective than litigation at reaching a compromise between the retiree and the employer, it does not ensure that the employer will be able to afford a fair compromise.[209] Of course, the traditional arbitration model, in which the arbitrator's role is only to interpret the contract between the employer and retiree, suffers from all the flaws of using a free contract system for retiree welfare benefits.[210]

### 4. VEBA

A fourth model Congress could employ is an expanded form of the Voluntary Employee Benefits Association (VEBA).[211]

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[206] This standard would be much like the business necessity test Congress has imposed on petitioners for bankruptcy in 11 U.S.C. § 1113 (1982). *See supra* notes 132–35 and accompanying text.

[207] This model is fundamentally different from the arbitration model employed in the collective bargaining context. There, the arbitrator merely interprets the language of the collective bargaining agreement. The arbitrator's value lies in her ability to reach a more rapid and accurate determination of the terms of the CBA than would a court. In the proposed model discussed here, the arbitrator would act similarly to a judge sitting in equity.

[208] This would require the arbitrator to consider the employer's business as a whole, ensuring that active workers were not harmed as a result of retirees' demands.

[209] One could also argue that if the restrictions on termination or modification of these plans are too great then the employer will not promise its active workers any retirement benefits in the first place. This is not necessarily objectionable because if the employer did not provide this form of defined compensation then the employer would have to provide compensation in a more immediate and therefore more secure form.

[210] *See supra* notes 165–74 and accompanying text.

[211] *See* 26 U.S.C. § 501(c)(9) (1982). VEBAs had the potential to be successful retire-

VEBAs, as originally instituted, were tax exempt organizations that collected funds from individuals or employers during the individual's employment and then distributed those funds to individuals during their retirement.[212] The administrator who controlled the VEBA funds was held to a fiduciary standard.[213]

VEBAs have the security of a bank account. Once an individual places funds in the account, she is assured that there will be funds available for retirement. The funds are independent of any employer, so that the employee need not fear that an employer will use the plan assets for improper purposes or that the employer will terminate the plan and provide no benefits. VEBAs also solve most of the portability problems.

Although VEBAs provide an excellent shell in which to put retiree benefit funds, they are not a comprehensive solution to the problem. VEBAs do not speak to governance of the employer-employee relationship. They do not address the creation of a retiree welfare benefit plan, nor do they address the conditions under which an employer can stop contributing to the VEBA.

By contrast, a comprehensive solution to the retiree health benefit problem must define the conditions under which the employer can promise contributions to the accounts. An employer should not be allowed to promise a "retiree welfare benefit plan" by merely making small regular contributions to a VEBA. If the employer stopped making those contributions the retirees would have not a plan, but rather a small fund devoted to retirement medical costs. A comprehensive solution must also consider the conditions under which an employer could limit or terminate its contribution to an account.

### 5. Individual Retirement Account

A fifth model which could be employed in a new system of retiree welfare benefits is the individual retirement account

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ment savings institutions despite the fact that they were cut back as part of DEFRA. *See* DEVELOPMENTS IN AGING, *supra* note 24, at 217. For example, one major insurance company (Metropolitan Life) put $70 million into VEBAs over a four-year period. Yet soon after Congress eliminated most of the tax advantages of VEBAs the company ceased using them. *See* U.S. NEWS & WORLD REP., *supra* note 53, at 72. During recent Congressional hearings on retiree health benefits, both employers and employees supported the reinstitution of VEBAs. *See, e.g., Retiree Health Benefits, supra* note 17, at 45, 75.

[212] *See* I.R.C. § 501(c)(9) (1979).

[213] Treas. Reg. § 1.501(c)(9)-2(c) (1981).

(IRA).[214] This is the perfectly portable model, with each employee contributing to and managing her own fund. The employer could indirectly contribute to these funds by increasing the employee's wages and by including in the employment contract a requirement that some portion of the wages be placed in an IRA.

The most obvious problem with the IRA model is that it has not provided individuals with sufficient incentive to save. Although IRAs have been well advertised by financial institutions, they have been used almost exclusively by the wealthy.[215] Americans' inability to save for retirement through consistent saving has not been changed by the incentive of tax deductible saving.

IRAs are also subject to early withdrawal despite the penalties incurred. Hard times eased by using IRA funds may lead to a crisis in retirement. IRAs may also fall victim to bad investments. While pension plans and VEBAs are managed by sophisticated investment advisers, many individual accounts are managed by individuals who have little knowledge of financial markets.

### 6. Social Security

A sixth model for consideration is the Social Security system. This model[216] requires the employer to contribute a percentage of the employee's salary to a government fund. That fund holds the contribution until the employee retires. It then pays out those contributions or provides some service during the individual's retirement. Such a program would address employer contribution, pre-funding, portability, and would assure retirees of a well-managed plan.

The primary problem with employing this model is the possibility that the government's role would evolve from banker and plan administrator to benefit provider.[217] The current Social Security system has transformed a savings system into a welfare

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[214] *See* 26 U.S.C. § 408 (1982).

[215] *See* Jackson, *Costs and Consequences of Tax Incentives: The Individual Retirement Account*, 94 HARV. L. REV. 864, 870 (1981).

[216] The model could be either non-voluntary like the current Social Security system, or voluntary.

[217] If Congress were interested in moving towards the socialization of health care, this model would provide the best pilot program. One must question, however, whether socialized medicine is the ultimate goal of the majority of Congress.

system.[218] Such a transformation may be protected against by allowing only those people who have paid into the system to receive benefits.

Even if the inter-generational transfer is eliminated, the government still bears the risk of becoming a benefit provider. If the actuarial calculations of the plan administrator are wrong — people live longer, medical costs increase unexpectedly, or individuals retire earlier — the government will have to make up the difference or let retirees go without important coverage. The likely political response, especially in light of the growing power of the elderly vote, would be to shore up the program and pay out more than was paid in.

The current dissatisfaction in Congress with the burden of the present Social Security program and the Medicare program is likely to prevent the creation of a new large scale retirement security program. Congress' most recent responses to similar problems have all focused on the private sector as the provider and administrator.[219]

All of the models outlined above have features which could be employed in a retiree health benefits program. The goals set out in the preceding section define which of the features of each of these programs would be helpful in constructing a comprehensive program for retiree welfare benefits. What follows is an argument for one type of program — a limited tax expenditure program — and an outline of a new program that is a hybrid of the models discussed above. This proposal seeks a compromise between the needs of retirees and employers.

### D. *Justifying a Tax Expenditure Program Over a Direct Aid Program*

The primary justification of an employer-sponsored tax expenditure program is that it would permit the government, with a relatively small amount of government resources, to encourage

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[218] This transformation had its roots in the inter-generational transfer. Older people who had never paid into the program received benefits when the program was first created. Those paying into the program received in return the promise that their retirement needs would be met by the contributions of the succeeding generation of workers. Now that the contributions of the successor generations are not able to cover the needs of the elderly, Social Security has become a tax on the young rather than a government-controlled savings system.

[219] *See supra* note 179.

employees and employers to set aside a large amount of funds for retirement medical costs. In essence, a tax expenditure program similar to ERISA would provide a "reward" in the form of tax-free savings to individuals who set aside funds for retirement health costs. By not taxing compensation which is set aside for retirement benefits, the government encourages employees to accept compensation in the form of a future benefit rather than a cash wage.[220] The result of a tax expenditure program can be full retirement coverage for those encouraged to save. In contrast, the result of a direct aid program is coverage of only the value of the funds the government contributes (i.e., the amount of the "reward").

Since a tax expenditure program is essentially a private savings system, there are some negative elements to it. Those who cannot save even if a reward is offered are not helped by such a program. Thus, critics have argued that such a plan would not reach the neediest of retirees.[221] Also, a relatively well-off employee who would have saved for retirement even without the tax expenditure program could reap a reward that need not have been paid. This could result in an inefficient use of resources.

The first problem can be solved only by providing for the poor through a direct aid program.[222] Yet, such a direct aid program would be much smaller than it would be without the tax expenditure program because it is targeted at a much smaller group of people. The second problem can be solved by putting some kind of income limitation on who may take a tax deduction for retirement welfare benefit savings.

A tax expenditure program is also easier and cheaper to administer than a direct aid program. The administrative costs in

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[220] For example, for every dollar paid in wages the employee realizes eighty cents (at a twenty percent tax rate). For every dollar put into a retiree benefit fund (instead of being paid as a wage), the employee realizes one dollar. With a reward of twenty cents, the government encourages an employee to set aside one dollar worth of benefits. This is, of course, a very simplified explanation of the workings of a tax expenditure. *See generally* S. SURREY & P. MCDANIELS, TAX EXPENDITURES (1985).

[221] Since a tax expenditure program is essentially a mechanism for encouraging employers to provide compensation in some form other than wages, all unemployed, underemployed, and minimum or near-minimum wage individuals would not benefit from a tax expenditure program.

[222] Those current retirees who will not benefit from the reforms listed above and those future retirees on whom an incentive to save has no effect will need direct aid of some form. This would be the third stage of a comprehensive solution to the retiree medical care problem.

setting up and monitoring a direct aid program would be much greater than simply using the pre-existing tax structure.[223]

A tax expenditure program which encourages personal saving for retirement health care also has the beneficial effect of encouraging active workers and retirees to plan for their future. If all present employees are to rely on direct governmental aid for medical insurance during their retirement, the government's cost for retiree insurance in thirty or forty years will be astronomical. Creating a system which provides an alternative to relying on government largess and which encourages rational planning for the future, even if it targets a smaller group than all those who are in need, will relieve Congress of a huge burden in the future.

A program primarily independent of government largess will also be free from politically motivated cut-backs in the future.[224] Just as the Supreme Court in *Pittsburgh Plate Glass* wished to protect retirees from the uncertainties of collective bargaining,[225] retirees' benefit plans should be protected from the uncertainties of partisan politics as much as possible.

A tax expenditure program also allows Congress to employ the most efficient combination of mechanisms to meet the medical needs of retirees. For employees who would not save on their own but could be encouraged to save, the tax expenditure "reward" would be used. For those who are not able to save, the government would provide a less efficient but necessary program of direct aid. For those who would save without any program, neither reward nor direct aid would be provided.

A tax expenditure program would also lay the foundation for a system which could eventually run without the need for a "reward." As the retiree population grows, active workers' awareness of the need for retirement security will increase. Those workers will demand, as a condition of their employment, that the employer set aside funds for retirement benefits. Employers are likely to choose the cheapest and most secure method for providing employees with retirement security. A

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[223] *See* S. SURREY & P. MCDANIELS, *supra* note 220, at 99–117.

[224] Even if Congress decides to eliminate the tax expenditure program after a number of years, a large number of individuals will have saved some amount to be used during their retirement. These savings would not vanish even if the government tax expenditure program did. In contrast, the termination of a direct aid program leaves retirees without health care and without having properly planned for retirement.

[225] *See* Allied Chemical and Alkali Workers v. Pittsburgh Plate Glass Co., 404 U.S. 157, 173 (1971).

program of the type discussed here is the likely candidate for such funds because for every dollar contributed by the employer the employee receives the government "reward."

At some point, employees' awareness of, and demand for, retirement security will be great enough for the employer to contribute to a secure retirement benefit program without the additional incentive of government "reward." Thus, creating a tax expenditure program now may lay the foundation for a future system of secure retirement benefits motivated by the market and borne entirely by the private sector.

A tax expenditure program would also encourage employers to include in their costs of production the benefit plan costs due in the future but incurred as the employee works. If the employer accounts for these future expenditures as current costs, its present cost of production will better approximate the actual cost of production. In other words, if employers put off until tomorrow the costs which they incur today, they are not recognizing the actual cost of each unit of their production. If the employer does not recognize the actual cost of production, then it will charge too little for its products.[226] Some time in the future, when the employer has to pay the benefits it has not accounted for, it will have to charge those costs to consumers. The net result is that the employer who fails to account for the actual costs of production will charge too little for current production and too much for future production.

Although this justification of a tax expenditure program may seem only theoretical, it has important practical implications. If the employer applies the correct cost to the goods produced at the time that they are produced, it will be able to calculate whether it can make a profit in the business. If recognizing the costs of a retiree welfare plan makes profits impossible, the employer will either eliminate the plan or go out of business immediately. If, on the other hand, the employer puts off accounting for retiree benefits, it will have to apply those costs to some future products. When those costs are applied to future products, the employer may not be able to make a profit. At

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[226] Employers are presently applying the costs of expenditures on retiree welfare benefits to the present costs of production. *See, e.g.*, Kurtz-Kasch Inc. and Metal Polishers, Buffers, Platers and Allied Workers International Union, 79-1 Lab. Arb. Awards (CCH) ¶ 8109, at 3459, 3462–63 (1978) (Chapman, Arb.). This means that products sold today reflect not the future cost of the active worker's benefits but rather the cost of past employees' present retirement needs.

that point the employer is likely to refuse to pay the retiree benefits promised to former employees and will either breach the contract or petition for bankruptcy. In essence, this economically correct accounting system will help prevent employers from making promises which they cannot fulfill.

### E. *Elements of the Stage II Program*

It is possible to provide retirees with nearly complete security, to provide active employees with substantial retirement security, and to allow employers some flexibility to meet economic downturns and stiff competition. A program which creates a number of tiers of vesting and pre-funding requirements and which carefully defines the prerequisites for planning termination or modification can meet these goals.

#### 1. Minimum Level of Benefits

Given the assumption that a program would be politically viable only if employers' participation was voluntary, there seems to be little sense in requiring a minimum level of benefits. Although Congress could require those employers who choose to participate in the program to provide a minimum level of benefits, such a requirement might discourage employers who wish to commit to a retiree benefit program but cannot afford the minimum level of benefits. Since any amount an employer is willing to commit to a retiree benefit plan is a positive contribution to the effort, discouraging any contributions which meet some basic requirements makes little sense.

#### 2. Minimum Pre-Funding

While a minimum level of benefits would not be wise, a minimum level of pre-funding is essential to a successful program. The only way to guarantee that employers will meet their promises of retirement welfare benefits is to require that they set aside funds as the benefits accrue.[227] Without pre-funding benefits, retirees are vulnerable to employers declaring bankruptcy

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[227] *See supra* notes 166–69 and accompanying text.

or simply shutting down production. Eliminating such vulnerability is the primary reason to create a new program.

A minimum level of pre-funding also forces the marginal benefit provider either to commit to a benefit program or to provide compensation in some other way. Allowing an employer to promise benefits without pre-funding opens the door for an employer to deceive its employees. An employer could use the promise of retirement benefits to encourage its employees to work for lower wages, and then breach the benefit agreement or declare bankruptcy. Pre-funding thus requires the marginally committed employer and the manipulative employer to either make a firm commitment to benefits or promise no benefits at all.[228]

Although pre-funding has its benefits, it also has its potential drawbacks. Congress should be wary of locking employers into pre-funding all promises made to employees. The more promises that the employer has to pre-fund, the less adaptable the employer is to sudden changes in the market.

Congress could use one of several measures for determining the minimum level of pre-funding. If the employer promises his employees a cash benefit due in each year of retirement, pre-funding could be a percentage of the total dollar value that the employer promises to his employees. Alternatively, if the employer promises a defined benefit plan,[229] pre-funding could be a percentage of the total projected dollar value of that benefit package. Finally, pre-funding could depend on some fixed dollar amount determined by Congress.

Rather than having the minimum level of pre-funding vary with each employer as would be the case in the first two options, Congress should require employers to pre-fund up to a fixed level of benefits. Congress would determine the minimum level of pre-funding by estimating the cost of the average retiree's future medical needs and then deciding which of those needs should be made secure with pre-funding. Of course, Congress' determination as to which needs are worthy of pre-funding is entirely subjective and will be a political rather than an economic decision.[230]

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[228] The assumption here is that by making no promise of benefits, the employer will be forced by the market to provide the compensation in some other form such as wages, current benefits, vacation time, etc.

[229] *See supra* note 52.

[230] Deciding on a level of pre-funding which depends on the projected health care

Employers who promise any level of retiree medical benefits would be required to pre-fund up to the minimum dollar level per employee that Congress sets. Employers who promise retiree benefits which amount to less than the pre-funding minimum would have to pre-fund all of what they promise. Employers promising more than the minimum level would pre-fund only up to the minimum level. Such a minimum level would not vary from employer to employer, nor would the level vary between an employer who promises its employees a cash benefit and an employer who promises a defined benefit program.

Defining the minimum level of pre-funding in this way assures retirees whose employers opt into the program that some level of benefits will be pre-funded. It would require the marginal benefit providers to make a firm commitment to their employees. It would allow providers of more generous benefits some flexibility in the way they fund their retiree benefits.[231]

### 3. Vesting

Congress should also mandate a multi-stage vesting requirement for retiree welfare benefits. Congress should require that pre-funded benefits (those receiving some sort of tax advantage) vest first. Benefits which are promised but not pre-funded may vest at some later point. Congress should, however, require that all benefits vest sometime before retirement. This would prevent the employer from defeating the expectations of older active employees and would remove the incentive for an employer to

needs of future retirees is a difficult task. First, Congress must decide what type of care should be pre-funded. Second, Congress must predict what that care will cost in thirty or more years. Third, Congress must calculate who will live past retirement age, how long they will live, and how often they will need the care provided. Solving the first problem is within Congress' expertise. The solution to the third problem is within the expertise of insurance companies. The second problem will be difficult for anyone to solve. The leaps in technology and the increasing standards of care are nearly impossible to predict over a thirty-year period.

[231] A related issue over which there has been some debate in the context of ERISA is the choice of formula used to calculate how much the employer must set aside each year to pre-fund a plan properly. Congress must decide which method is best to pre-fund the programs. *See generally Here Today, Gone Tomorrow?*, *supra* note 13, at 48 (report exploring the different methods available for pre-funding retirement health benefits).

fire an employee just before retirement to avoid the benefit liability.[232]

4. Process for Modifying Benefit Plans

The third feature of the new program would be some mechanism for the employer to change all benefits except those that are both funded and vested. Here Congress should employ a two stage process of bargaining and mandatory arbitration. Employers wishing to amend their plans for either present employees or retired employees would be allowed to do so but only if they met stringent business necessity standards. Those standards would be similar to the standard employed in section 1113 of the Bankruptcy Act.[233] An employer wishing to change the non-vested portions of its plan would need to meet a less strict standard of business necessity than an employer wishing to change the unfunded, vested portion of its plan, since those individuals subject to a change in the non-vested portions (the active employees) are not as vulnerable as retirees to changes in retirement programs. Active employees can bargain for a different form of compensation or even seek a new employer who would provide better retirement benefits. Those beneficiaries of the vested benefits, the retirees and near-retirees, have fewer options than younger, active workers and have worked longer with the expectation that they would receive the benefit package.

The first step in the process of amending or terminating the retiree benefit plan would be bargaining. The employer would have a duty to bargain in good faith with the plan beneficiaries. A framework similar to section 1113 of the Bankruptcy Act could be used.[234] Those beneficiaries who have a union for an exclusive bargaining agent would employ the union represen-

232 There would thus be four categories of benefits under this new program: non-vested, funded benefits (benefits below the minimum level of funding but not yet vested, held by new employees); non-vested, unfunded benefits (benefits above the minimum promised which do not vest until the employee reaches the second stage of vesting, held by younger and middle-aged employees); vested, unfunded benefits (benefits above the minimum level of funding and vested, held mostly by older employees); vested, funded benefits (benefits below the minimum level of funding already vested, held by retirees who have met the first vesting requirement, and also benefits above the minimum level of funding that vested later in the employee's career held by older employees and retirees).

233 11 U.S.C. § 1113(c) (1982). *See supra* note 135.

234 *See supra* text accompanying notes 132–37.

tative to bargain with the employer. Those beneficiaries without union representation would need to elect or have appointed a representative.

Bargaining serves as a first step in requiring the employer to disclose to the beneficiaries its reasons for seeking to change the plan. Bargaining also provides a framework in which solutions can be reached rapidly. At a bargaining session the employer could offer to provide some other package of benefits as a substitute for the current retiree benefits. The parties could make a deal that would allow the employer to cut back on retiree benefits temporarily. This compromise may allow the employer to bolster its business and then to return the lost benefits. Bargaining would also allow the beneficiaries to propose some compromise that would be suitable to them.

If any one of the beneficiary representatives is resistant to the employer's proposal, then she may initiate mandatory arbitration, which provides a less burdensome alternative than resorting to the courts. A solution could be reached more rapidly, the standards of evidence need not be strictly applied, the endless pretrial jousting which usually occurs in litigation would be eliminated, and an expert on the industry rather than a judge would be the arbiter of the dispute.[235]

The standards for business necessity outlined above[236] would be applied by the arbitrator to determine whether the employer was in a sufficiently desperate situation to relieve it of its obligations to beneficiaries. The arbitrator would also have the ability to work out some compromise that meets the comparative needs of the parties. For instance, the arbitrator could make a preliminary ruling as to his opinion of the business necessity and then suggest that the parties agree to some compromise such as exchanging some benefits for stock in the company.

If any representative disagrees with the result or the method of the arbitration she may appeal to the federal district court.[237]

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[235] The arbitrator would have duties much like those of an administrative law judge. There are some questions as to whether the delegation of this power to a private arbitrator is within the bounds of Article III and the Due Process Clause of the Constitution. *See generally* Commodities Futures Trading Comm'n v. Shor, ____ U.S. ____, 106 S. Ct. 3245 (1986); Thomas v. Union Carbide, 473 U.S. 568 (1985).

[236] *See supra* note 135.

[237] Although the Bankruptcy Court would be more qualified to hear the appeal from the arbitrator's decision because of its expertise with these types of analyses under section 1113, the requirements of Article III of the Constitution limit the effect of the Bankruptcy Court's review. Since an Article III court must hear the case at some point, it is in the interest of efficiency to give the appeal to a federal district court.

The district court's review would be limited to the same scope of review applicable to administrative decisions, likely utilizing the "based on sufficient evidence" standard.[238]

During this process, the employer would be required to continue providing unfunded vested benefits until either the arbitrator or the court decided that the employer could amend or terminate the plan. In the case of non-vested benefits, there would be a rebuttable presumption of continuing the plan until an arbitrator or court found otherwise.

From the employer's perspective, this process allows some flexibility in the retiree welfare benefit plan. In the bargaining context, the employer need not even meet a required standard of business necessity. If the employer can convince the beneficiary representatives that it is in the beneficiaries' best interest to opt for a cut-back in the benefit package[239] or that the employer has a good chance of success in arbitration or court, the employer need not meet the standards set out above. In the arbitration context, the employer could press the arbitrator for some compromise solution that a court could not give. In court, the employer is in much the same situation that it is in now.

From the employee's point of view, this process provides tough standards for terminating or amending a benefit plan. It also allows for a more fine-tuned response to the employer who is in a difficult economic situation. Rather than being subjected to the on-off switch of a court decision, beneficiaries could keep some of their benefits while allowing the employer to continue operations.

This process dovetails with the collective bargaining model of the NLRA. Bargaining over retiree welfare benefits could be part of the regular collective bargaining negotiations. Unions could bargain for more benefits at any time they wished. Unions could also bargain to lower benefits for any beneficiaries who were properly represented by the union under *Pittsburgh Plate Glass*.[240] If the employer tried to force a position on the union concerning retiree benefits, the union could break off negotiations on that subject and initiate arbitration. An employer who

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[238] *See* Crowell v. Benson, 285 U.S. 22, 52 (1932).

[239] A compromise may be in the best interest of the beneficiary when the viability of the business is threatened. It may be that a temporary cut in the benefits allows the employer to get over a difficult period.

[240] Allied Chemical and Alkali Workers v. Pittsburgh Plate Glass Co., 404 U.S. 157 (1973). *See supra* note 195.

tries to force a cut-back in retiree benefits onto the union during regular CBA negotiations might also be held in violation of the duty to bargain in good faith under section 8(d) of the NLRA.

Bargaining for retirees and non-union active employees would not take place within the NLRA framework. A more analogous situation would be bargaining under section 1113 of the Bankruptcy Act. Ideally, representatives for these beneficiary groups would be chosen by majority vote. The same standards of exclusive representation that apply in the collective bargaining context[241] or the class action context[242] would apply. If the beneficiary group was unable to agree on a representative, the employer could petition a court to appoint one.

While the process does not constrict the employees' ability to request more benefits or to bargain for different types of benefits, it does restrict the kind of bargain an employer can make with its employees. Once an employer agrees to a program it can no longer unilaterally amend or terminate it even if it has written that power into the contract. Although this restriction may discourage some employers from agreeing to increases in benefits, the model intends to discourage those marginal employers who are not committed to retiree benefits. The marginal employers could compensate their employees in some more immediate and secure way than making an unreliable commitment to retiree benefits.

### 5. Portability and Individual Accounts

The fourth major feature of this plan reinstitutes VEBAs,[243] or some similar independent non-profit organization for the purpose of administering welfare benefit programs. This feature solves the portability problem and accommodates employees wishing to start their own retiree welfare benefit program. Employees whose employer is willing to create a welfare benefit plan would have the choice of whether the pre-funded plan was to be kept in a company fund or in a VEBA. Employees could shift the funds from an employer's plan to a VEBA, or from

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[241] *See* 29 U.S.C. § 159 (1982) ("representatives designated or selected for the purposes of collective bargaining . . . shall be the exclusive representatives of all of the employees in such a unit").

[242] *See* FED. R. CIV. P. 23(a)(3), (a)(4).

[243] *See supra* text accompanying notes 211–12.

VEBA to VEBA on some restricted basis such as that applied to IRAs.[244]

The new VEBAs would also provide employees who have no employer-sponsored benefit plans with some method of saving for retirement medical expenses. Employees could have their employer directly deposit part of their paycheck into a VEBA. Employees could also contribute a limited amount of funds on their own as they would to an IRA.[245]

### 6. Reporting and Disclosure

To ensure that all beneficiaries could participate in the process of modifying a benefit plan and that employers properly pay promised funds into VEBAs, the new program must include a system of reporting, disclosure, and notice similar to ERISA. Vested employees who switch employers before retirement must be notified and consulted when the employer wishes to modify a plan. Violations of the disclosure and reporting standards would result in both fines and equitable remedies against the employer.

### 7. Functional Description of the Program

The program would function as follows: an employer promises retirement benefits to its employees. Assume the value of those benefits is equivalent to ten dollars per week per employee. Assume also that the legislation fixes the minimum pre-funding at five dollars per employee per week. The employer is therefore required to pre-fund half of the promised benefits. The pre-funded portion of the benefits must vest within some fixed period of time determined by Congress (e.g., within five years). The remaining benefits must also vest sometime before retirement (i.e., at some pre-determined age or number of years that the employee has worked for the company).

A number of years after promising the benefits the employer falls victim to a financial crisis. It chooses to alleviate the crisis in part by cutting back on its retiree benefit program. It cannot touch the vested, pre-funded portion of its program. To change

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[244] *See* 26 U.S.C. § 408 (1982).

[245] Since the VEBA would be managed by professional investment advisers and would be subject to reporting requirements, the contributor would not be as likely to suffer from bad investments as she would in an IRA. *See supra* text following note 215.

the vested, unfunded obligation—benefits promised to active employees who have reached age fifty-five and retirees—the employer must meet a higher standard of business necessity. To change the non-vested obligation—benefits promised to the younger active employees—the employer must meet a lower standard of business necessity.

To begin the process of modifying the benefit plan the employer must notify the representatives of the various beneficiary groups. If there is no existing representative and no beneficiary comes forward to organize a representative election, the employer may petition the court to appoint a representative for the group.

After representatives are selected, the parties enter the bargaining stage. An employer may bargain with all the representatives as a group or with each representative individually so long as no agreement between an employer and a representative forecloses an equally favorable agreement with another group of beneficiaries. If no agreement is reached, the employer or any representative can request arbitration.[246] The arbitrator would make a preliminary decision on the employer's business necessity and would propose some compromise. If the parties did not agree to the compromise, then the arbitrator would reach a final decision on the employer's business necessity. If the employer wins at this point, it may alter the benefit program as allowed by the arbitrator.

Finally, the arbitrator's decision as to business necessity will be reviewable by a federal district court.

### 8. The Program in Sum

Viewed from the employer's perspective, this new program allows a fair amount of flexibility. First, the employer has the choice to participate in the program. If an employer chooses to provide an employee with higher wages or direct contributions to a VEBA with no tax deduction, then the program does not apply.[247] The employer also has the option of administering its

[246] For the sake of reaching a quick decision, the bargaining should be limited to a period of several months. If a decision is not made in that time and all of the parties do not agree to extend the bargaining time, then mandatory arbitration would automatically begin.

[247] The difference between the direct VEBA contribution and the vested program is that in the direct contribution context the employer has made no promise of future benefits.

own welfare benefit fund or using a VEBA. Finally, in the case of the employer who promises more than it pre-funds, the program allows some flexibility in those promises.

Viewed from the employee's perspective, the program provides that employers cannot renege under any circumstances on some pre-funded level of retiree benefits. Other retiree benefits can only be changed if there is some substantial economic reason for doing so. Pre-funded portions of the retiree welfare benefit plan are guaranteed by the fact that the money is already set aside. Unfunded promises are protected by a process and a legal standard.

In economic terms, the program makes one portion of retiree benefits a fixed cost of production and the other portion a qualified variable cost of production. The fixed cost benefits are allotted to the most vulnerable benefit group while the qualified variable cost benefits are allotted to the least vulnerable group. Such a combination of fixed and variable costs achieves the necessary compromise between the employer's need for flexibility and the employee's need for retirement security.

## Conclusion

The proposals outlined above provide a framework in which to make both present and future retirees' employer-sponsored retirement health benefits more secure. The first set of proposals corrects many of the flaws in the present system of free contract. The second set of proposals outlines a new system for future retirees.

The primary premise of the proposals is that at least for employer-sponsored plans, benefits must reflect the promise made by the employer to his employees. Current retirees must find their solution within the bounds of their employer's past promise. Future retirees must make secure agreements with their employers for future benefits.

This Note argues that leaving the provision of retiree health care to free contract has been unsuccessful. The proposals for reform reflect this argument. Both sets of proposals move the provision of employer-sponsored benefits away from free contract and toward a more secure and predictable system.

The proposals outlined above do not solve the problems of all retired individuals who are without health benefits. A comprehensive solution to this problem would include a third stage consisting of direct government aid to those present and future retirees who do not benefit from employer-sponsored plans. It is time for Congress to recognize this need now in order to be adequately prepared for the future.

# COMMENT

# PROHIBITING THE USE OF THE HUMAN IMMUNODEFICIENCY VIRUS ANTIBODY TEST BY EMPLOYERS AND INSURERS

NANCY PERKINS*

Acquired Immune Deficiency Syndrome (AIDS) is a deadly disease that currently threatens millions of lives. AIDS is also a disease that because of its devastating effects, communicability, and high costs of treatment is disrupting the provision of health-related benefits in this country. Employers, insurers, and administrators of public welfare programs must grapple with the economic and social costs of AIDS. Employers face pressures from employees who refuse to work alongside persons whom they know or suspect to have AIDS, and from customers who threaten to withdraw their patronage because they are uncomfortable dealing with companies that employ people who have the disease. Insurers, who currently cover much of the extremely high health care costs of many AIDS patients, face ongoing liabilities to cover such persons' life insurance benefits. Administrators of public welfare programs must struggle to defray the medical costs of AIDS patients who are eligible for benefits.

To minimize the impact of AIDS on their businesses, both employers and insurers seek to identify persons at risk with respect to the disease. In particular, they attempt to screen out individuals who have been exposed to the Human Immunodeficiency Virus (HIV), the virus that causes AIDS. Currently, the most effective means of identifying an asymptomatic individual (one who exhibits no symptoms of AIDS but has been exposed to the HIV) is the HIV antibody test, which detects antibodies naturally developed by the body's immune system to fight off the virus. Although several states have banned the use of this test by employers, insurers, or both, most states have no official policy regarding test use by either group. Generally, this lack of legal guidelines has encouraged ad hoc behavior toward

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asymptomatic HIV carriers, persons who have AIDS, and those who are perceived as "at risk" of developing the disease.

This Comment analyzes the costs and benefits of HIV antibody testing by employers and insurers and proposes a four-part legislative solution to the screening problem. It recommends that states 1) prohibit both employers and insurers from inquiring into the results of HIV antibody tests voluntarily taken in the past by current or potential employees or by applicants for insurance, 2) either prohibit the use of test results to determine eligibility for employment or, as an alternative, declare persons who test HIV-positive handicapped for purposes of handicap discrimination laws, 3) prohibit the use of test results to determine eligibility for health insurance, and 4) permit the use of test results to determine life insurability only under strict regulatory guidelines.

In addition to this legislative proposal, the Comment recommends that states establish health insurance pooling organizations, to which all insurers within each state be required to belong, that will provide insurance to all persons considered uninsurable by individual companies. States should also provide subsidies to those municipal hospitals currently bearing a disproportionate share of AIDS patients' costs, and encourage home and hospice care for those AIDS patients for whom hospitalization is not clearly necessary. Finally, states should undertake a widespread effort to educate all citizens about AIDS and its transmission while offering free, confidential HIV antibody testing and comprehensive counseling to all who wish it.

## I. Background

### A. *The Nature of the Disease*

AIDS is a viral disease that renders the human immune system defenseless against certain fatal illnesses. The HIV infects certain white blood cells, T-Lymphocytes (T-cells), which play a crucial role in the body's ability to ward off illness. When the HIV enters a T-cell, it produces an enzyme that allows it to transcribe its genetic material onto that of the T-cell, thus altering the cell and impeding its growth and replication. The HIV may remain dormant in the T-cells, causing no further damage to the immune system. If, however, the infected T-cells replicate, the simultaneously reproduced HIV can attack other healthy T-cells and eventually destroy all non-infected cells.

HIV infection of T-cells prevents the production of antibodies that normally ward off bacterial, viral, and fungal parasites. The proliferation of these parasites results in a variety of associated diseases, including lymphadenopathy (enlarged lymph nodes), Kaposi's sarcoma (cancer of the blood and/or lymphatic vessel walls), pneumocystis carinii pneumonia, gastrointestinal disorders, and other opportunistic infections. The symptoms of these diseases occur at various stages. Individuals in whom the HIV is at an intermediate stage of infection may experience enlarged lymph nodes, weight loss, persistent fevers, coughing, or night sweats. Such persons are commonly diagnosed as having AIDS-related complex (ARC). As these symptoms become more severe, the individual is increasingly disabled; eventually, he or she may develop what is called "full-blown AIDS."[1] The average lifespan of a diagnosed AIDS patient ranges between eight and thirty months.[2]

The HIV is a fragile virus, capable of transmission from one individual to another only through the exchange of a bodily fluid.[3] The virus has been isolated in blood, semen, saliva, tears, breast milk, and urine. It appears to be most commonly transmitted during sexual intercourse, blood transfusions, the sharing of intravenous needles, the use of blood-clotting medications, and prenatal or natal exposure. Because the virus cannot survive outside the body long enough to be spread through food, drinking fountains, utensils, or toilet facilities, its carriers pose no risk to those with whom they engage in casual contact.[4]

Despite the limited means of transmitting the HIV between individuals, AIDS has spread rampantly during the past decade. In 1982, there were 1,336 reported cases of AIDS in the United States;[5] by October 1987, the number had reached 42,353.[6] In

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[1] The Centers for Disease Control (CDC) define AIDS as an acquired immune deficiency associated with one or more specified life-threatening infections and cancers. NATIONAL ACADEMY OF SCIENCES, CONFRONTING AIDS 73 (1986) [hereinafter NATIONAL ACADEMY OF SCIENCES].

[2] *Id.*

[3] *Id.* at 50.

[4] U.S. DEP'T OF HEALTH AND HUMAN SERV., SURGEON GENERAL'S REPORT ON ACQUIRED IMMUNE DEFICIENCY SYNDROME 13 (1987) [hereinafter SURGEON GENERAL'S REPORT].

[5] Lambert, *AIDS Rise Spurs Debate on Testing of Victim's Sex Partners*, N.Y. Times, Jan. 27, 1987, at B1, col. 2.

[6] Sullivan, *AIDS Deaths in New York are Showing New Pattern*, N.Y. Times, Oct.

this country alone, 22,548 AIDS patients died as of 1987.[7] Current projections are that the case load will reach 270,000 by 1991, with 170,000 deaths.[8] According to the National Academy of Sciences (NAS), between 1 and 1.5 million Americans are currently infected with the virus,[9] 50,000 to 125,000 of whom already show symptoms of ARC.[10] The NAS predicts that at least twenty-five to fifty percent of all infected persons will develop AIDS within five to ten years of infection.[11]

### B. *The Costs of AIDS*

#### 1. Direct Costs

The direct health care costs of treating AIDS patients have been difficult to assess, in part because in-hospital care costs vary widely between different states.[12] In 1985, the Centers for Disease Control (CDC) estimated that average hospital expenditures for the in-patient care of an AIDS patient from the time of diagnosis until death totaled $147,000.[13] More recently, a California study produced a much lower estimate of $60,000–70,000 per patient.[14] Based on these more recent figures, the United States Public Health Service has predicted that the total costs of care for the approximately 174,000 AIDS patients expected to be alive in 1991 (excluding those with ARC) will be between $8 and $16 billion in that year alone.[15] In comparison

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22, 1987, at B4, col. 5. As of February, 1987, the distribution of adult AIDS cases in this country was as follows: 66% homosexual men, 17% intravenous drug users, 8% homosexual intravenous drug users, 4% heterosexuals, 2% blood transfusion recipients, 1% hemophiliacs, and 3% undetermined. Knox, *Researchers Cite Spread of AIDS Among Heterosexuals*, Boston Globe, Feb. 23, 1987, at 1, 6, col. 2.

[7] Christensen, *The Life Insurance Industry Requests the Right to Use AIDS Antibody Testing as an Underwriting Factor*, TR. & EST., Aug. 1987, at 58.

[8] Lambert, *supra* note 5, at B1, col. 2.

[9] NATIONAL ACADEMY OF SCIENCES, *supra* note 1, at 5.

[10] *Id.* at 7.

[11] *Id.*

[12] Fox, *The Costs of AIDS from Conjecture to Research*, 2 AIDS & PUB. POL'Y J. 25, 26 (1987).

[13] *See* Hardy, Rauch, Echenberg, Morgan & Curran, *The Economic Impact of the First 10,000 Cases of Acquired Immunodeficiency Syndrome in the United States*, 255 J. A.M.A. 209, 209–10 (1986). The Centers for Disease Control based this estimate on an average lifetime use of 168 hospital days, an average survival time of 392 days, and an average charge per hospital day of $878. *See id.*

[14] *See* Scitovsky, Cline & Lee, *Medical Care Costs of Patients with AIDS in San Francisco*, 256 J. A.M.A. 3103, 3106 (1986).

[15] NATIONAL ACADEMY OF SCIENCES, *supra* note 1, at 159.

with other health care costs, the cost of AIDS represents a relatively small, but growing, portion of total personal health care expenditures: estimates indicate that AIDS- related health care costs reached $630 million in 1985 (0.2% of total health care expenditures), grew to $1.1 billion in 1986 (0.3% of total health care expenditures), and will grow to $8.5 billion in 1991 (1.4% of total health care expenditures).[16]

#### 2. Indirect Costs

The indirect costs of AIDS include the value of lost output due to illness, permanent disability, and premature death.[17] These costs are extremely high, primarily because the great majority of AIDS victims are between twenty and forty years of age, and thus in their most productive years.[18] Moreover, the disease promises to account for a growing portion of the nation's total indirect costs due to illness. According to a recent study, the indirect costs of the 15,400 AIDS patients presumed to be alive in 1985 were $3.9 billion (1.2% of total national indirect costs), rose to $7.0 billion in 1986 (2.1% of total national indirect costs); and by 1991, will reach $55.6 billion (12% of the total national indirect costs).[19]

### C. *Covering the Costs of AIDS*

#### 1. Medicaid

Medicaid, a joint federal-state program, provides financing for the medical care of all Aid to Families with Dependent Children (AFDC) recipients and most Supplemental Security Income (SSI) recipients (the aged, blind, and disabled). In 1983, the Social Security Administration's Office of Disability Programs declared that persons diagnosed as having CDC-defined AIDS are to be presumed disabled for purposes of SSI eligibility. If such persons meet certain income standards, they can receive

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[16] Scitovsky & Rice, *Estimates of the Direct and Indirect Costs of Acquired Immunodeficiency Syndrome in the United States, 1985, 1986, and 1991*, 102 PUB. HEALTH REP. 5, 14 (1987).
[17] *Id.* at 11.
[18] *Id.* at 8.
[19] *Id.* at 7–8.

Medicaid benefits through an abbreviated determination process in a majority of states.[20]

According to the Health Care Financing Administration (HCFA), forty percent of all AIDS patients currently receive Medicaid benefits.[21] In some states, the percentage may be as high as sixty-nine percent.[22] The HCFA has established that the federal share of Medicaid coverage of AIDS patients in 1985 was $50 million, and predicted that this figure would double in 1986.[23] In California, the State Department of Health Services estimates that the state's Medicaid program paid out $4.5 million in benefits to AIDS patients in fiscal year 1984, and that, assuming twelve percent of all AIDS patients in California are eligible for benefits, this funding will total $96.3 million in fiscal year 1990.[24] Costs in New York, where both the number of AIDS patients and the proportion of Medicaid recipients are greater, are projected at $25 million for 1987, and are expected to increase by $18 million per year once the state approves a number of comprehensive AIDS care centers.[25] New Jersey expects to spend $67.6 million treating Medicaid-eligible patients over the next three years.[26]

### 2. Medicare

Medicare, a federal program, helps finance health care for elderly persons (persons over age sixty-five), permanently disabled persons, and persons with end-stage renal disease. Medicare benefits are available to the elderly only if they qualify for Social Security (i.e., if they have, as employees, contributed to the Social Security trust fund), and to disabled persons only after they have received Social Security benefits for two years. Because AIDS patients are generally well under age sixty-five, they are likely to qualify for Medicare benefits only as disabled persons; as the great majority of AIDS patients fail to survive

[20] NATIONAL ACADEMY OF SCIENCES, *supra* note 1, at 163.
[21] *Id.* at 162.
[22] *Id.*
[23] *Id.* at 163–64.
[24] *Id.* at 164.
[25] *Cuomo Seeks $12.5 Million for AIDS Programs in State*, AIDS Pol'y & L. (BNA) No. 5, at 7 (Feb. 11, 1987).
[26] *HHS Grants Waiver to Treat AIDS, ARC Patients at Home*, AIDS Pol'y & L. (BNA) No. 5, at 7 (Feb. 11, 1987) [hereinafter *HHS Grants Waiver*].

for two years, only one to three percent of them are likely to benefit from Medicare.[27]

### 3. Private Health Insurance

Between eighty-five and eighty-eight percent of all Americans carry private health care insurance.[28] Private health care insurance providers include Blue Cross and Blue Shield, health maintenance organizations, commercial insurance companies, and self-insured employers. An increasing number of employers (currently, around fifty percent of all employers)[29] provide health benefits through self-financed plans. These plans are exempt from state insurance laws and are regulated instead under the Employee Retirement Income Security Act of 1974 (ERISA).[30] The primary advantage of self-insurance is that it enables employers to monitor their own benefit provisions, rather than subjecting themselves to premium rating by insurance companies.

According to insurance company estimates, approximately 158 million Americans under age sixty-five belong to group health insurance plans, and another 9 million maintain individual policies.[31] The vast majority of group plans cover employees of companies or firms. Employee groups generally enjoy broad coverage at relatively low rates due to favorable tax treatment of employers, contributions to insurance premiums, and reductions in risk associated with insuring large numbers of relatively healthy persons. Competition to insure these groups has minimized administrative costs and prompted insurers to employ "experience rating," which tailors rates exclusively to the costs incurred by each group's members, rather than "community rating," which charges different groups in a given area the same premium. Due to risk-spreading among more policyholders and lower administrative costs per capita, larger employee groups generally pay lower premiums than smaller ones. The few very small firms that maintain group plans are usually charged pre-

[27] NATIONAL ACADEMY OF SCIENCES, *supra* note 1, at 165.
[28] *Id.*
[29] Oppenheimer & Padgug, *AIDS and Health Insurance: Social and Ethical Issues*, 2 AIDS & PUB. POL'Y J. 11, 13 (1987).
[30] 29 U.S.C. §§ 1001–1461 (1982).
[31] HEALTH INS. ASS'N OF AM., PUBLIC RELATIONS DIVISION, SOURCE BOOK OF HEALTH INSURANCE DATA: 1987 UPDATE (1987) (forthcoming publication).

miums based on the health status of individual employees, rather than on a group experience basis.

Persons ineligible for group health insurance can usually obtain individual policies. These individual policies generally provide fewer benefits at higher costs than do group plans. Insurance premiums for these policies vary according to the policyholder's personal health status. Of course, coverage may be denied altogether to those persons deemed most at risk. In a 1985 survey of 325 life and health insurance companies across the nation, every company reported that it considers AIDS an "uninsurable" condition.[32] Thus, if an applicant for individual insurance has AIDS, he or she is automatically denied coverage. In addition, ninety-nine percent of the surveyed companies deem persons with ARC uninsurable, and ninety-one percent refuse to insure anyone who has tested positive for HIV antibodies or for a suppressed immune system.[33]

Nevertheless, many of these companies have financed, and will continue to cover, the health care costs of AIDS patients, both through group policies and under policies obtained by individuals prior to the onset of AIDS. The 1985 survey found that 155 companies had incurred medical expense claims totalling $23,756,728 for 657 AIDS patients, averaging $36,159 per claimant.[34] By 1987, two of the nation's largest insurance companies reported vast combined payment figures for the health and life insurance claims of AIDS patients: Lincoln National Life Insurance Company reported payments of $10 million on 250 health and life insurance policies; The Travelers Companies reported payments of $2.5 million on 59 health and life policies.[35]

### 4. Private Life Insurance

Unlike private health insurance, most private life insurance is purchased on an individual basis. As of 1986, individual policies represented 53.6% of all life insurance in force in the

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[32] *See* AMERICAN COUNCIL OF LIFE INS. AND HEALTH INS. ASS'N OF AM., AIDS SURVEY OF MEMBER COMPANIES 1 (1985) [hereinafter ACLI-HIAA SURVEY].

[33] *Id.* A 1986 survey of 324 life and health insurers also found that 91% deem "uninsurable" anyone who tests positive for HIV antibodies. Bock, *A Burden Too Heavy to Bear*, TIME, Aug. 31, 1987, at 39.

[34] ACLI-HIAA SURVEY, *supra* note 32, at 3.

[35] Tuller, *Trying to Avoid an Insurance Debacle*, N.Y. Times, Feb. 22, 1987, § 3, at 8, col. 2.

United States.[36] Insurers rate premiums for individually-purchased life insurance according to an applicant's mortality risks. This clearly renders AIDS and ARC victims uninsurable, and according to the results of the survey discussed above, almost always deprives HIV seropositives (those who test positive on the HIV antibody test) of coverage.[37] The survey shows that of the 325 responding companies, 105 reported having incurred disability claims on 308 AIDS patients, totalling $9,106,191 and averaging $29,566 per claimant.[38] Death claims averaged $33,471 per individual, totalling $34,274,717 for the 215 companies that incurred them.[39] Statistics on individual company experiences by February, 1987, indicate that TransAmerica had paid out $6.2 million on 68 AIDS-related life insurance claims and that Northwestern Mutual's payments totalled $6.5 million on 87 such claims.[40]

### D. *HIV Antibody Testing*

#### 1. The Tests

There are two standard tests used to identify individuals who have been exposed to or are infected with the HIV. Both tests detect antibodies to the virus in the blood serum. The enzyme-linked immunosorbent assays (ELISA) test is the most widely used because of its accuracy, relative low cost,[41] and ease of performance. This blood-screening test is extremely "sensitive" in identifying the tested-for condition, but also produces a relatively high rate of false positive results.[42] A more accurate indicator of a person's HIV status is the Western Blot test. The Western Blot test, although considerably more expensive[43] and time-consuming to perform, is generally considered capable of

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[36] AMERICAN COUNCIL OF LIFE INS., 1986 LIFE INSURANCE FACT BOOK 17 (1986).
[37] *See* ACLI-HIAA SURVEY, *supra* note 32, at 1.
[38] *Id.* at 3.
[39] *Id.* at 4.
[40] Tuller, *supra* note 35, § 3, at 8, col. 2.
[41] The Red Cross charges hospitals and doctors $15 per ELISA test; other laboratories charge more. Knox, *Testing Policy For Blood Recipients Causes Alarm*, Boston Globe, Mar. 22, 1987, at 26, col. 1.
[42] *See* NATIONAL ACADEMY OF SCIENCES, *supra* note 1, at 113–14.
[43] The Western Blot test costs approximately $100 to perform. Levine & Bayer, *Screening Blood: Public Health and Medical Uncertainty*, AIDS: THE EMERGING ETHICAL DILEMMA 9 (Hastings Center Report Special Supplement) (Aug. 1985).

confirming the presence of HIV antibodies in a person who has tested positive on the ELISA test.[44]

Any diagnostic testing program is most efficient when administered to a population in which there is a high prevalence of the tested-for condition. Illustrative of this is the experience of a Massachusetts state-administered HIV antibody testing program: until January, 1987, the program was limited to testing people at a high risk for AIDS and produced a relatively high rate of positive results (approximately ten percent).[45] An influx of lower-risk subjects between January and March reduced that rate to five percent, and during the second two weeks of March, the rate of positive testees dropped to one percent.[46] The cost implications of these data are worth noting: at a ten percent positive rate, it cost the state $1,000 to identify a single HIV carrier; at five percent, it cost $2,000; at one percent, it cost $10,000.[47] These figures suggest that employers and insurers will want to administer the HIV antibody test selectively, testing only those persons they perceive to be most at risk for HIV exposure.

### 2. Testing by Employers

Relatively few employers in the private sector use HIV antibody tests to screen current or potential employees.[48] In public employment, however, the Federal Government has taken an aggressive approach to HIV antibody screening; it now requires all military personnel, Job Corps participants, and foreign service employees of the State Department to submit to HIV antibody testing.[49]

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[44] *See* NATIONAL ACADEMY OF SCIENCES, *supra* note 1, at 114; Bayer, Levine & Wolf, *HIV Antibody Screening: An Ethical Framework for Evaluating Proposed Programs*, 256 J. A.M.A. 1768, 1769 (1986).

[45] Knox, *supra* note 41, at 26, col. 3.

[46] *Id.*

[47] *Id.*

[48] *See, e.g.*, *Companies Taking Low-Key Approach to AIDS in the Workplace, Survey Finds*, 4 Empl. Rel. Weekly (BNA) 291 (March 10, 1986). There are, however, exceptions. For example, the Enserch Corporation in Dallas screens its food service employees for HIV antibodies. Hamilton, Flynn, Houston & Rhein, *The AIDS Epidemic and Business* (special section), BUS. WK., Mar. 23, 1987, at 124.

[49] *See* Bayer & Levine, *Risks of Federal Screening*, N.Y. Times, Jan. 12, 1987, at A21, col. 3.

### 3. Testing by Insurers

Insurer HIV antibody testing is widespread. According to a 1985 survey conducted by the Health Insurance Association of America (HIAA) and the American Council of Life Insurance (ACLI), almost sixty percent of all the insurance companies surveyed require applicants to take HIV antibody tests, although none mandate testing of all applicants.[50] Most of these companies use combined ELISA, Western Blot, and T-Cell tests. Approximately eighty-five percent of the companies that responded to the survey require an attending physician's statement regarding the applicant's HIV status; twelve percent specifically request applicants to report their HIV status on their application forms.[51]

## II. Testing and the Law

### A. *Employment*

HIV testing by employers constitutes predictive screening in that it evaluates the probability that an individual will be unable to work in the future. Predictive health screening always involves speculation, but numerous factors have been correlated with increased risk of future health problems, including genetics, biochemistry, physiology, and behavior. Unless these factors are inherently linked to classifications that by law are invalid bases for discrimination (i.e., race and generally sex), employers are free to use them to weed out employees. A few states have enacted laws prohibiting employment discrimination based on sickle cell traits;[52] New Jersey has banned discrimination with respect to any "atypical hereditary cellular or blood trait" including sickle cell, Tay-Sachs, and others.[53]

Both state and federal employment discrimination laws prohibit employers from unfairly discriminating against persons classified as "handicapped." These laws provide the most likely basis upon which HIV testing could be deemed to discriminate

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[50] *See* ACLI-HIAA SURVEY, *supra* note 32, at 2.

[51] *See id.*

[52] FLA. STAT. ANN. § 448.075 (West 1981); LA. REV. STAT. ANN. §§ 23:1000–:1004 (West 1985); N.C. GEN. STAT. § 95-28.1 (1985).

[53] N.J. STAT. ANN. § 10:5-5(y) (West Supp. 1981).

unfairly against AIDS victims. On the federal level, the Rehabilitation Act of 1973 (Rehabilitation Act)[54] prohibits federal agency employers and programs receiving federal funds from discriminating against the handicapped,[55] and further requires that these agencies and programs adopt affirmative action programs with respect to such persons.[56] On the state level, all fifty states and the District of Columbia maintain statutes or executive orders prohibiting employment discrimination against the handicapped or disabled either by public employers, private employers, or both.[57] In general, these laws closely track the language of the federal Rehabilitation Act.

Both courts and legislatures have almost uniformly determined that handicap discrimination laws apply to persons with AIDS and ARC.[58] As of 1986, twenty states and the District of Columbia had officially declared AIDS to constitute a handicap for purposes of their employment discrimination laws; five others had issued informal recommendations that AIDS-based discrimination be deemed improper, and an additional eight had indicated willingness to accept or investigate AIDS discrimination complaints.[59]

The federal government also has taken steps to declare AIDS victims handicapped for the purposes of federal law. On June 25, 1986, the Justice Department prepared a memorandum for the Department of Health and Human Services stating that the disabling effects of AIDS and its related conditions constitute handicaps under the federal Rehabilitation Act.[60] The Justice Department memorandum also states, however, that "an individual's (real or perceived) ability to transmit the disease to others is not a handicap within the meaning of the statute."[61]

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[54] 29 U.S.C. §§ 701–796 (1982).

[55] *Id.* at §§ 791, 794.

[56] *Id.* at §§ 791(b), 793.

[57] *See, e.g.*, CONN. GEN. STAT. ANN. § 46a-58 (West 1981); N.Y. Human Rights Act, N.Y. EXEC. LAW § 296(a) (Consol. 1983); Penn. Human Relations Act, PA. STAT. ANN. tit. 43, § 955 (Purdon Supp. 1987).

[58] The most authoritative federal judicial decision on the issue to date is Chalk v. United States, No. 87-6418 (9th Cir. Nov. 18, 1987) (holding that the Rehabilitation Act authorized requiring the Orange County Department of Education to reinstate a teacher with AIDS).

[59] *See* NATIONAL GAY RIGHTS ADVOCATES, AIDS AND HANDICAP DISCRIMINATION: A SURVEY OF THE 50 STATES AND THE DISTRICT OF COLUMBIA (1986) [hereinafter NGRA SURVEY].

[60] Office of Legal Counsel, U.S. Department of Justice, Memorandum for Ronald E. Robertson, General Counsel, Department of Health and Human Services (June 25, 1986) (on reserve at the Harvard Law School Library) [hereinafter Justice Dep't Memo].

[61] *Id.* at 1.

The Rehabilitation Act defines a handicapped individual as "any person who 1) has a physical or mental impairment which substantially limits one or more of such person's major life activities,[62] 2) has a record of such an impairment, or 3) is regarded as having such an impairment."[63] Rejecting the notion that the communicability of a disease could itself constitute an "impairment" as defined by the Act, the Justice Department concluded that federal handicap discrimination law does not prevent an employer from discriminating against an asymptomatic HIV carrier unless he or she is inaccurately perceived as having AIDS or ARC.[64]

The ramifications of the Justice Department's opinion have yet to be determined. In response to a 1986 survey of all fifty states and the District of Columbia, no state agency indicated that it would join the Justice Department in permitting discrimination based on an individual's real or perceived ability to transmit AIDS.[65] Nevertheless, absent explicit legislative declarations that asymptomatic HIV carriers are handicapped, resolution of the issue rests with the courts.[66]

Should a jurisdiction accept the Justice Department's position that positive HIV status does not constitute a handicapping condition for the purposes of employment discrimination laws, employers would not be barred, in the absence of contrary legislation, from screening workers for the presence of the virus. To date, the only states that have enacted laws that regulate use of the HIV antibody test by employers are California,[67] Flor-

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[62] "Major life activities" under the statute include caring for oneself, performing manual tasks, walking, seeing, hearing, speaking, breathing, learning, and working. 45 C.F.R. § 84.3(j)(2)(ii) (1985).

[63] 29 U.S.C. § 706(7)(B) (1982).

[64] *See* Justice Dep't Memo, *supra* note 60, at 1.

[65] *See* NGRA SURVEY, *supra* note 59.

[66] Some defenders of the rights of victims of AIDS believe that the United States Supreme Court's decision in School Board of Nassau County v. Arline, 107 S. Ct. 1123, *reh'g denied*, 107 S. Ct. 1913 (1987), holding that the contagious effects of tuberculosis constitute a handicap under the Rehabilitation Act, promises protection for asymptomatic HIV carriers under handicap discrimination laws. *See, e.g.*, Taylor, *Justices Support Disease Victims*, N.Y. Times, Mar. 4, 1987, at A1, col. 5. This interpretation of *Arline* seems tenuous. The Court explicitly declined to analogize asymptomatic HIV carriers to victims of tuberculosis, and referred to an argument based on this analogy as "misplaced" because, while the status of HIV infection as an impairment under the Act has yet to be determined, "tuberculosis [gives] rise both to a physical impairment *and* to contagiousness." 107 S. Ct. at 1128 n.7 (emphasis in original).

[67] CAL. HEALTH & SAFETY CODE §§ 199.20–.40 (West Supp. 1987) (prohibiting both testing without written consent and using test results for determining employability).

ida,[68] Massachusetts,[69] and Wisconsin.[70] Several California cities, however, including Los Angeles[71] and San Francisco,[72] as well as Austin, Texas[73] and Philadelphia, Pennsylvania,[74] have enacted ordinances or executive orders prohibiting AIDS-related employment discrimination that inclusively protect asymptomatic HIV seropositives and persons perceived to be in a high risk group.

In considering whether to prohibit employer use of the HIV antibody test and its results, it is important to bear in mind that an alternative to a test-use prohibition is officially declaring positive HIV status a handicap for purposes of handicap discrimination laws. Either the testing ban or the expanded handicap definition would inhibit employment discrimination against carriers of the virus. Although this paper focuses on the choice to ban use of the test and its results, it does not assume that this is the optimal means of protecting HIV carriers against discrimination. This focus merely streamlines the discussion of testing in the employment and insurance contexts. Thus, in determining whether to regulate the use of HIV status in employer decision-making, states should not overlook their option to declare HIV carriers handicapped for purposes of state employment discrimination laws.

### B. *Insurance*

Historically, the insurance industry has been regulated exclusively by the states. The McCarran-Ferguson Act,[75] passed by Congress in 1945, provides that insurance is to be regulated entirely by the states except when federal legislation "specifically relates to the business of insurance."[76] State insurance

[68] FLA. STAT. § 381.606(5) (1985) (prohibiting the use of test results for employment purposes).

[69] MASS. GEN. LAWS ANN. ch. 111, § 70F (West Supp. 1987) (prohibiting the requirement of submission to testing as a condition of employment).

[70] WIS. STAT. ANN. §§ 103.15(2)(a), .15(2)(b), .15(3) (West Supp. 1987) (prohibiting use of the test for employment purposes unless the state epidemiologist determines that AIDS-infected persons "may, through employment, provide a significant risk" of transmitting the virus to others).

[71] LOS ANGELES, CAL. CODE art. 5.8, §§ 45.80–.93 (1985).

[72] SAN FRANCISCO, CAL. POLICE CODE art. 38, §§ 3801–3816 (1985).

[73] AUSTIN, TEX., ORDINANCES No. 801211-V (Dec. 11, 1986).

[74] Philadelphia, Pa. Exec. Order No. 4-86 (Apr. 15, 1986).

[75] 15 U.S.C. §§ 1011–1015 (West 1982).

[76] *Id.* at § 1012(b).

departments have broad authority to regulate private insurance companies within their state,[77] but their regulatory powers do not extend to self-insured employers, which are governed by ERISA.

Much state insurance regulation is based on model legislation drawn up by the National Association of Insurance Commissioners (NAIC), a national organization of state insurance regulators. Of particular importance in the context of insurance for AIDS victims is state legislation based on the NAIC's Model Unfair Trade Practices Act (the Unfair Trade Practices Act).[78] This Act empowers state insurance commissioners to issue cease and desist orders to life and health insurers that engage in certain proscribed acts, including "unfair discrimination."[79] Since 1960 all fifty states and the District of Columbia have maintained regulations that embody provisions of the Unfair Trade Practices Act in various forms,[80] and generally the states grant their insurance commissioners wide latitude to proscribe insurance practices that are not specifically prohibited under the Act.

Recently, the NAIC approved a model bulletin entitled "Medical/Lifestyle Questions on Applications and Underwriting Guidelines Affecting AIDS and ARC."[81] This bulletin aims to prevent insurance discrimination against homosexuals as a group known to be at high risk for developing AIDS. The bulletin forbids life and health insurers to inquire into an applicant's sexual orientation or to use sexual orientation as a criterion in the underwriting process. It also prohibits the use of factors such as gender, marital status, living arrangements, occupation, beneficiary, medical history, and zip code or other territorial classification as proxies for an applicant's sexual orientation. If implemented by state insurance commissioners, the bulletin's guidelines should provide important protection for persons who are healthy but at high risk of HIV exposure.

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[77] In some states, the state health department rather than the insurance department regulates health maintenance organizations.

[78] *An Act Relating to Unfair Methods of Competition and Unfair and Deceptive Acts and Practices in the Business of Insurance*, 1972 PROCEEDINGS OF THE NAIC 512 § 4(7)(a), (b), *reprinted in* OFFICIAL NAIC MODEL INSURANCE LAWS, REGULATIONS AND GUIDELINES, §§ 880-1 to 880-5 (1978).

[79] *Id.*

[80] *See* Lamel, *State Regulation of the Insurance Industry*, 665 INS. L.J. 336, 339 (1978).

[81] NATIONAL ASS'N OF INS. COMM'RS, MEDICAL/LIFESTYLE QUESTIONS AND UNDERWRITING GUIDELINES (1987) (proposed bulletin).

The NAIC has not reached a consensus, however, on the issue of life and health insurer testing of applicants for HIV antibodies. Although insurance companies have questioned the authority of state insurance commissioners to prohibit insurer use of the HIV antibody test,[82] the federal district court for the District of Columbia recently affirmed that states have the power to ban such testing. In *American Council of Life Insurance v. District of Columbia*,[83] the court rejected the industry's argument that a District of Columbia law prohibiting insurer use of all AIDS-related tests for a five-year period[84] violates the due process clause of the federal Constitution.[85] In reaching its decision to uphold the law, however, the court questioned the wisdom of the prohibition, stating that "new evidence on the accuracy of AIDS tests for insurance purposes and the ever changing breakthroughs in AIDS research raises serious questions about imposing a five-year ban on screening applicants for AIDS."[86] It remains to be seen if other legislative bans on insurer testing will withstand judicial scrutiny.

In fact, only a few other jurisdictions have prohibited insurer use of the HIV antibody test. In 1986, the Massachusetts Insurance Commissioner issued a complete ban on testing by health insurers; a subsequent attempt to codify this regulation has been temporarily enjoined.[87] In August, 1987, the New York State Superintendent of Insurance prescribed regulations prohibiting both testing and inquiring into prior test results for health insurance purposes, but not for life insurance purposes.[88] In April, 1985, the California legislature enacted a law barring use of the test "for the determination of insurability."[89] Also in

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[82] *See, e.g.*, Kahn, *Tests of Will*, Boston Phoenix, Mar. 10, 1987, at 12, col. 3 (reporting that at least 31 insurance companies in Massachusetts have challenged the Massachusetts Insurance Commissioner's authority to prohibit their use of HIV antibody tests and are continuing to test in defiance of the ban); *Insurance*, 2 AIDS UPDATE 5 (1987) (reporting that two insurance trade groups and seven individual insurance companies filed suit against the New York State Superintendent of Insurance, contesting the validity of regulations prohibiting life insurer HIV antibody testing).

[83] 645 F. Supp. 84 (D.D.C. 1986).

[84] D.C. CODE ANN. §§ 35-221 to -229 (Supp. 1987).

[85] *See* 645 F. Supp. at 88. The court also rejected the claim that the law violates the District of Columbia Self-Government and Governmental Reorganization Act. *See id.* at 89.

[86] *Id.* at 88.

[87] Life Insurance Association of Massachusetts v. Singer, No. CV 87-5321 (D. Mass. Sept. 28, 1987) (order granting preliminary injunction preventing 211 CMR 36.00 from taking effect, as planned, on October 2, 1987).

[88] N.Y. COMP. CODES R. & REGS. tit. 11, § 52.1 (1987).

[89] CAL. HEALTH & SAFETY CODE § 199.21(f) (West Supp. 1986).

1985, Wisconsin adopted a statute prohibiting insurers from requiring applicants either to take an HIV test or to reveal the results of any such test taken under other circumstances.[90] A subsequent amendment to the Wisconsin statute, however, permits insurer HIV testing if the state epidemiologist finds the test "medically significant and . . . reliable."[91] After the state epidemiologist actually made such a finding in July, 1986, the Wisconsin Insurance Commissioner proposed a rule that would allow insurers to require HIV antibody tests in underwriting individual health, life, and accident insurance policies.[92] If that rule is adopted, testing presumably will resume.

As of June 1, 1987, California, Florida, Maine, and the District of Columbia were the only jurisdictions that completely banned insurers from using HIV antibody tests as an underwriting factor.[93] In five other states, insurance departments have declared it their policy to prohibit HIV testing or inquiries into prior test results.[94] The departments in five additional states authorize testing but forbid inquiries into prior test results.[95]

## III. Testing: The Arguments

### A. *For Employer Testing*

One justification for predictive medical screening of employees is that it identifies individuals who will be unable to work in the future. In general, this justification is legally sufficient only if supported by a showing of very high risk of future inability to work,[96] and that the disabling condition will prevent the afflicted individual from working for a "reasonable period

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[90] Wis. Stat. Ann. § 631.90 (West Supp. 1986).

[91] *Id.*

[92] *See Proposed Rule Would Allow Use of HIV Tests in Wisconsin*, 1 AIDS Pol'y & L.'(BNA) No. 23, at 1 (Dec. 3, 1986).

[93] Christensen, *supra* note 7, at 59. New York state has since promulgated regulations governing testing for life insurance purposes. *See supra* text accompanying note 88.

[94] The five states are Arizona, Delaware, Massachusetts, Michigan, and North Dakota.

[95] The five states are Connecticut, Minnesota, Nevada, New Jersey, and South Dakota. *See* National Gay Rights Advocates, Results of National Insurance Survey (Jan. 21, 1987) (Press Release).

[96] *See, e.g.*, Black v. Marshall, 497 F. Supp. 1088 (D. Haw. 1980) (indicating that only if a risk of inability to work is so immediate as to constitute a present inability will it support a denial of employment).

of time."[97] Although an employer would have no difficulty showing that an HIV carrier who developed full-blown AIDS would be unemployable for a "reasonable period of time," ARC is not necessarily disabling for a "reasonable" time period. Furthermore, the statistical likelihood that an asymptomatic HIV carrier will develop either AIDS or ARC within several years is low.[98] Therefore, this justification is unpersuasive with respect to testing employees for the HIV.

A second justification for employer screening is that it can reveal the presence of conditions that pose a serious threat to the health and safety of co-employees or customers. As support for HIV antibody testing, this argument is factually weak. To justify denying employment to a person with a threatening condition, the employer must show that employing the applicant would create a "reasonable probability of substantial harm" to others.[99] According to the National Academy of Sciences, Institute of Medicine, the risk of transmitting the HIV in a workplace environment is almost nonexistent.[100] Even in occupational contexts where the risk of HIV transmission might be thought to be greatest—health care, personal services, and food services—the Centers for Disease Control have recommended against routine workplace screening.[101] In light of the scientific evidence on HIV transmission, policy officials have already rejected the argument that AIDS-afflicted individuals pose a health risk to co-employees.[102]

A third argument in favor of allowing employers to use HIV tests as a screening device is that it allows them to reduce the costs of employee health care plans. This argument requires an assumption that HIV seropositive individuals are not handicapped, because employers are barred from discriminating against the handicapped in order to avoid contributing to health

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[97] *See, e.g.*, CAL. ADMIN. CODE tit. 2, § 7293.8(d)–(e) (1980) (defining "reasonable period of time" as dependent upon 1) the nature of the handicap, 2) the length of the training period required for the job, 3) the type of time commitment routinely required for all other employees for the particular job, and 4) the normal workforce turnover).

[98] *See supra* text accompanying note 11.

[99] Mantolete v. Bolger, 767 F.2d 1416, 1422 (9th Cir. 1985).

[100] Bayer and Levine, *supra* note 49, at A21, col. 4.

[101] *See* Centers for Disease Control, *Guidelines on AIDS in the Workplace*, 34 MORBIDITY AND MORTALITY WEEKLY REPORT 682 (1985).

[102] *See, e.g.*, Baily, *Hiam May Allow Testing for AIDS*, Boston Globe, Mar. 25, 1987, at 65, col. 6 (reporting on a decision of the Massachusetts Commission Against Discrimination that denial of work to a former bank employee with AIDS was unfairly discriminatory in light of a doctor's finding that he presented no threat to co-workers).

care or other benefit costs.[103] The problem with this argument is that most states now consider AIDS and ARC to be handicaps for the purposes of employment discrimination laws, and the obvious cost-related goal of HIV antibody screening is to weed out persons likely to develop either of these conditions. Thus, justifying a denial of employment to HIV carriers on the ground that they may incur higher than average costs than other employees seems a mere facade for escaping the now relatively widely adopted conclusion that AIDS and ARC victims deserve handicap protection.

### B. *For Insurer Testing*

The insurance industry argues that HIV testing is necessary to comply with state mandates of fundamental fairness. All state insurance codes currently maintain requirements for fair treatment of insured persons. These requirements are modeled on those of the NAIC's Model Unfair Trade Practices Act ("Model Trade Practices Act"), which declares illegal:

> (a) making or permitting any unfair discrimination between individuals of the same class and equal expectation of life in the rates charged for any contract of life insurance . . . ;
> (b) making or permitting any unfair discrimination between individuals of the same class and having essentially the same hazard in the amount of premium, policy fees, or rates charged for any policy, contract of accident or health insurance or . . . in any manner whatever.[104]

The state laws based on these sections of the Model Trade Practices Act aim to achieve equity for policyholders by prohibiting insurers from differentiating between persons with similar risks. The laws require insurers to assess each policyholder's premium on the basis of that individual's predicted morbidity and mortality costs. These laws thus protect insured persons from paying excessive amounts to subsidize policyholders in higher risk groups.

Currently, insurers assess morbidity and mortality risks by evaluating factors that include health history, physical condi-

[103] *See e.g.*, McDewott v. Xerox Corp., 65 N.Y.2d 213, 480 N.E.2d 695, 491 N.Y.S.2d 106 (1985); Chrysler Outboard Corp. v. Dilhr, 14 Fair Empl. Prac. Cases (BNA) 344 (Wis. Ct. App. 1976).

[104] NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS UNFAIR TRADE PRACTICES MODEL BILL 493–501 (1972 Proceedings of the NAIC I as amended 1985).

tion, sex, occupation, and alcohol or tobacco use. Although the use of some of these factors has been challenged as unfairly discriminatory and a few states have enacted laws prohibiting their use on that ground, generally only race is considered an invalid criterion for evaluating an individual's insurability.[105]

The insurance industry argues that because the repeated ELISA-Western Blot test has proven to be almost 100% accurate in identifying the presence of HIV antibodies, it should, like other indicators of health risks, be taken into account in calculating insurance premiums.[106] Citing an estimate that a thirty-four year old male who tests positive on the repeated ELISA-Western Blot test is, over a seven-year period, twenty-six times more likely to die than someone in standard health,[107] insurers claim that state law requires them to classify HIV-positive individuals separately from other persons for insurance rating purposes.[108] It would be fundamentally unfair, they argue, to require relatively healthy policyholders to subsidize the costs of health care and life insurance benefits for individuals whose mortality risks are as high as those of HIV carriers.[109]

The insurers buttress this fairness argument with evidence that individuals who are infected with the HIV engage in the adverse selection of insurance coverage.[110] Adverse selection in the insurance context is the tendency of persons with high health risks to apply for or continue to maintain a greater degree of health and life insurance coverage than persons with standard health expectations. According to the Health Insurance Association of America (HIAA) and the American Council of Life Insurance (ACLI), the findings of a 1985 survey of their member companies indicate that approximately forty-four percent (by total claim amounts) of all AIDS-related life insurance claims

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[105] *See* Wortham, *Insurance Classification: Too Important to be Left to the Actuaries*, 19 J.L. REFORM 349 (1986).

[106] *See, e.g.*, Blaine, *Regulatory Issues for Life and Health Insurers*, 2 AIDS & PUB. POL'Y J. 2 (1987); Iuculano, *D.C. Act 6-170: The Five-Year Ban on Risk-Based Pricing for AIDS*, 2 AIDS & PUB. POL'Y J. 15 (1987).

[107] Comparatively, over a seven-year period smokers have a death rate twice as high, and diabetics have a death rate four times as high as persons in standard health. *See* Tuller, *supra* note 35, § 3 at 8, col. 4.

[108] Health Insurance Association of America and American Council of Life Insurance, Statement to the Health Insurance (B) Committee of the National Association of Insurance Commissioners on AIDS and the Recommendations of the NAIC Advisory Committee on AIDS 10 (1986) [hereinafter HIAA-ACLI Statement to the NAIC].

[109] *See id.* at 6–7.

[110] *See id.* at 16.

have occurred in the first two years after the policy's issuance.[111] The insurers argue that unless they are able to test applicants for HIV antibodies or to inquire into past test results, they and their policyholders will be unfairly forced to subsidize the insurance costs of HIV carriers who engage in adverse selection.[112]

Generally, two types of regulation protect insurers against adverse selection: proscriptions against applicant misrepresentations and provisions regarding preexisting conditions. The industry claims that neither type of regulation adequately prevents adverse selection with respect to AIDS.

Under current law, an insurer can deny benefits to a policyholder if it can prove that the policyholder made misrepresentations, omissions, or incorrect statements on his or her insurance application. To prove this the insurer must show that 1) the misrepresentations, omissions, or incorrect statements were fraudulent; 2) the misrepresentations were material to the acceptance of the risk by the insurer; or 3) the insurer would not, in good faith, have issued the policy, either at the same premium or at all, had the true facts been made known.[113] State insurance codes, however, limit the insurer's ability to deny benefits on grounds of applicant misrepresentation through so-called "incontestability clauses."

An incontestability clause operates like a statute of limitations with respect to certain insurer defenses against policyholder claims.[114] The purpose of the clause is to prevent the insurer from contesting the validity of a policy after a specified period of time. The clause does not prevent an insurer from denying benefits on the ground that a particular loss is not covered by the policy, suing to reform the policy, or terminating a policy due to nonpayment of premiums or in violation of other policy provisions. It does, however, prevent the insurer from challenging benefit claims on the ground of policyholder misrepresentation.[115]

In most states, life insurance incontestability clauses become operative two years after a policy is issued. Misrepresentations

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[111] *Id.* at 16–17.

[112] *See id.* at 17.

[113] *See* Wissner v. Metropolitan Life Ins. Co., 395 F.2d 204, 205 n.1 (5th Cir. 1968); *see also* Hyman v. Life Ins. Co., 481 F.2d 441, 442 n.1 (5th Cir. 1973).

[114] 18 G. COUCH, COUCH ON INSURANCE §§ 72:1–:14, :16 (2d ed. 1983).

[115] 43 AM. JUR. 2D *Insurance* §§ 765–766 (1982).

regarding most conditions become apparent before the two-year contestability period is up, but misrepresentations of HIV seropositivity might well not be discovered for a longer time period. According to the United States Public Health Service, the average latency period between infection with the HIV and overt AIDS is at least four years.[116] Consequently, if an HIV carrier applying for life insurance misrepresented his or her HIV status, there is a high probability that the insurer would be unable to contest his or her claims for coverage of AIDS-related expenses when the disease actually develops.

The insurance industry believes that HIV carriers, justifiably concerned about their future health risks, may have a perverse incentive to misrepresent their HIV status on insurance applications. Banning the use of HIV antibody tests, the industry argues, will prevent insurers not only from initially charging these potential AIDS victims a premium fairly related to their actual health risk, but also from denying benefits when misrepresentations become evident.[117]

Even absent any risk of applicant misrepresentations, the insurance industry similarly believes that the latency period between HIV infection and the appearance of AIDS symptoms justifies testing applicants for the HIV. Many disability benefit and medical expense plans contain "preexisting conditions" clauses, which serve to protect insurers against adverse selection by excluding or limiting benefits for an illness that existed during a specified period prior to the commencement date of plan coverage. Almost all individual plans, most group health plans that cover less than 100 persons, and some group plans covering more than 100 persons contain such provisions.

Insurers contend that they cannot properly apply preexisting conditions clauses to AIDS-related claims unless they are able to ascertain the HIV antibody status of applicants. Most states define a "preexisting condition" as the "existence of symptoms which would ordinarily cause a prudent person to seek diagnosis, care, or treatment."[118] Assuming that after testing HIV antibody-positive a prudent person would seek medical advice, the insurers accurately assert that testing for or inquiring into

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[116] *See* UNITED STATES PUB. HEALTH SERV., PUBLIC HEALTH SERVICE PLAN FOR THE PREVENTION AND CONTROL OF AIDS AND THE AIDS VIRUS 5 (June 4–6, 1986) (report of the Coolfont Planning Conference).

[117] *See* Blaine, *supra* note 106, at 6.

[118] *See, e.g.*, N.Y. COMP. CODES R. & REGS. tit. 11, § 52.2(u) (1982).

an applicant's HIV antibody status would enable them to use preexisting conditions clauses to prevent adverse selection by potential AIDS victims.

A final argument for insurer testing is that if banned from testing, the industry may not be able to afford to offer individual policies at all. To support this argument, the insurers cite the fact that since the District of Columbia banned insurer use of the HIV antibody test in 1985, an estimated eighty percent of the 600 insurance companies there stopped selling policies to individuals in the District.[119]

Although to date, AIDS claims for either health or life insurance have been relatively modest,[120] insurance officials estimate that by 1991 the annual total cost of AIDS to their industry could well exceed $10 billion.[121] Insurers attribute much of this projected cost increase to the fact that they plan to continue to offer group coverage, which does not involve individual applicant screening, to groups that may include future AIDS victims. The industry argues that in continuing to provide group coverage it is treating AIDS like any other disease, and that fairness concerns dictate that it be able to do the same with respect to individual insurance.[122] The insurers claim that fairness demands that they be able to screen individual applicants for HIV antibody seropositivity by conducting their own tests or by inquiring into prior results.

### C. *Against Testing*

Although some arguments against HIV testing apply specifically to either employer or insurer testing, many apply in both contexts. Probably the principal argument against mandatory testing by either group is that it can lead to unfair discrimination. According to the Centers for Disease Control, approximately sixty-six percent of the total number of reported adult AIDS victims in the United States (excluding intravenous drug users)

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[119] Hamilton, Flynn, Houston & Rhein, *supra* note 48, at 126. According to a survey of 50 companies that sold the largest volume of individual life insurance policies in the District in 1985, 41 ceased offering such policies after the testing ban became effective. Boodman, *D.C. AIDS Law Spurs Exodus of Insurers*, Washington Post, Jan. 28, 1987, at C1, col. 5.

[120] *See supra* text accompanying notes 38–39.

[121] Tuller, *supra* note 35, § 3, at 8, col. 1.

[122] *See* HIAA-ACLI Statement to the NAIC, *supra* note 108, at 6–7; Tuller, *supra* note 35, § 3, at 8, col. 4.

have been identified as homosexual men.[123] Although recent statistics indicate that the proportion of AIDS cases attributable to heterosexual contact is increasing,[124] the disease currently is, and will foreseeably continue to be, heavily concentrated in the homosexual male population.[125] Gay rights advocates, concerned about the general public perception of AIDS as a "gay disease," fear unfair discrimination against homosexuals based on this perception.

Although presumably obtaining HIV antibody test results could actually serve to protect seronegative homosexuals from unfair treatment by insurers, test administration itself can be discriminatory. According to one insurance industry representative:

> The major threat to the insurance industry at present is largely confined to the homosexual population. . . . If we could somehow use [antibody] testing on this population, results could be expected to be *very* reliable. . . . On the other hand, to use [antibody testing] in a nonselective, random screening, manner seems to be very much a mistake at this time. We would not want to lobby for this privilege. Our efforts should be to push for the right to use [the test] in high prevalence settings.[126]

The recently promulgated NAIC guidelines forbidding insurers to inquire into applicants' sexual orientation should help to prevent insurer discrimination on the basis of sexual preference in states that adopt them. Nevertheless, these guidelines say nothing about selective HIV antibody testing. Thus, applicants are likely to have difficulty proving that such selective testing constitutes sexual orientation discrimination. Anticipating this difficulty of proof, gay rights advocates urge states to ban testing entirely rather than permitting insurers to test only persons they suspect are homosexuals.[127]

In the employment context, discrimination is a concern not only for homosexuals, but for all HIV carriers. As suggested

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[123] Knox, *supra* note 6, at 6, col. 1.

[124] Altman, *Fact, Theory and Myth on the Spread of AIDS*, N.Y. Times, Feb. 15, 1987, at A1, col. 4.

[125] *See* Knox, *supra* note 6, at 6, col. 4.

[126] Daniel F. Case, Actuary, ACLI & Karen A. Clifford, Attorney, HIAA, Memorandum to the ACLI Committee on Risk Classification (Aug. 14, 1985) (quoting the notes of Dr. Donald Chamber, Chair of the Drafting Group) (on file at Harvard Journal on Legislation).

[127] *See, e.g.*, Scherzer, *AIDS and Insurance: The Case Against HIV Antibody Testing*, 2 AIDS & PUB. POL'Y J. 19, 21 (1987).

above,[128] HIV seropositivity has only ambiguous implications regarding the carrier's ability to perform a job. The fact that significantly less than half of all persons who test HIV antibody-positive are likely to develop AIDS within five years of infection[129] renders the test at best a rough predictor of future job performance. Even those HIV carriers who do develop AIDS or ARC may be able to continue working; since ARC is not always debilitating, it may not interfere with one's ability to hold a job at all. Denying jobs to asymptomatic HIV carriers not only can cause severe financial and psychological hardship to the carriers themselves, but also imposes high costs on society in the form of lost productivity and the provision of increased unemployment benefits.

Discrimination against AIDS victims has been widespread—not only in employment and insurance—but also in numerous other contexts.[130] The threat of such discrimination has led to serious concern over the confidentiality of HIV test results, prompting many to oppose mandatory testing altogether. Opponents of testing believe an absolute testing ban may be the only way to prevent the kind of "exaggerated fears and behavior"[131] that has frequently been inspired by uncertainty about AIDS and its transmission.

In the insurance context, the confidentiality of policyholders' and applicants' medical information is respected, but not absolutely protected. Although the ACLI has encouraged states to enact laws similar to the NAIC's Insurance Information and Privacy Protection Model Act ("Insurance Model Act"), which restricts the dissemination of individual insurance records,[132] to date only ten states have adopted such laws. Even in states that have adopted the Insurance Model Act, insurers may exchange information in some circumstances without the knowledge of their insureds.[133] In addition, many insurance companies participate in the Medical Information Bureau, a centralized databank

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[128] *See supra* text accompanying notes 96–99.

[129] *See* SURGEON GENERAL'S REPORT, *supra* note 4, at 12.

[130] *See, e.g.*, Ricklefs, *AIDS Cases Prompt a Host of Lawsuits*, Wall St. J., Oct. 7, 1987, at 39, col. 4; Hamilton, Flynn, Houston & Rhein, *supra* note 48, at 124.

[131] Comment, *Protecting Confidentiality in the Effort to Control AIDS*, 24 HARV. J. ON LEGIS. 315, 321 (1987).

[132] *See* INSURANCE INFORMATION AND PRIVACY PROTECTION MODEL ACT (Model Regulation Service 1984), *reprinted in* LAW JOURNAL SEMINARS-PRESS, AIDS: LEGAL ASPECTS OF A MEDICAL CRISIS 512–14 (1986) [hereinafter INSURANCE MODEL ACT].

[133] *See id.* § 13(c) (limiting disclosure of information to that which is "reasonably necessary").

containing information collected by participating companies. The databank can be accessed by any participating insurer and is subject to government subpoena.[134] Moreover, at least six states require test laboratories to report the names of individuals who test positive for HIV antibodies to state officials.[135] Thus, despite the insurance industry's general respect for confidentiality, it is currently impossible to guarantee that HIV test results obtained by insurers will consistently remain private.

Even if absolute confidentiality were possible, some argue that mandatory testing for insurance, employment, or any other purpose violates the individual's constitutionally guaranteed right to privacy.[136] According to this view, unwanted disclosures of HIV test results abrogate the right to control information about oneself,[137] including the individual's right not to know his or her own HIV status.[138] Those who hold this view thus believe that the HIV antibody test should be administered only to volunteers.

Whether or not a constitutionally protected privacy right to test results exists, health officials may eventually determine that the benefits of mandatory testing outweigh the individual's right to confidentiality in circumstances where the risk to others is especially high. Nevertheless, the rationales for such a determination are unlikely to justify generalized testing for employment purposes.[139] More than one commentator has observed that the use of test results in contexts where an individual's economic and social well-being is at stake discourages voluntary testing, which in turn is critical to halting the spread of AIDS.[140]

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[134] Tuller, *supra* note 35, § 3, at 8, col. 4; Kahn, *supra* note 82, at 19, col. 1.

[135] The six states are Colorado, Idaho, Minnesota, Montana, South Carolina, and Wisconsin. Morganthau, *Future Shock*, NEWSWEEK, Nov. 24, 1986, at 30, 39; *see States Move to Tighten Rules for Reporting, Tracing HTLV-III*, 1 AIDS Pol'y & L. (BNA) No. 6, at 1 (Apr. 9, 1986) (discussing Arizona, Idaho, Montana, and Minnesota reporting requirements).

[136] *See* Leonard, *AIDS and Employment Law Revisited*, 14 HOFSTRA L. REV. 11, 44 (discussing the notion of testing as a violation of privacy rights); Note, *The Constitutional Rights of AIDS Carriers*, 99 HARV. L. REV. 1274, 1287 (1986) (same) (citing Whalen v. Roe, 429 U.S. 589, 599 (1977)).

[137] *See* Whalen v. Roe, 429 U.S. 589, 599 (1977).

[138] *See* Morganthau, *supra* note 135, at 39 (quoting statement of Harvey Fineburg, Dean of the Harvard School of Public Health). *But see* Bayer, Levine & Wolf, *supra* note 44, at 1770 (1986) (arguing that persons have an "obligation to know their [HIV] antibody status, to inform their sexual partners and to modify their behavior").

[139] *See supra* text accompanying note 4.

[140] *See, e.g.*, Bayer, Levine & Wolf, *supra* note 44, at 1771–73; Scherzer, *supra* note 127, at 21; *see generally* Altman, *Mandatory Tests for AIDS Opposed at Health Parley*, N.Y. Times, Feb. 25, 1987, at A1, col. 4 (reporting that the Centers for Disease Control has recommended against mandatory testing and in favor of widespread voluntary testing).

Another major argument against allowing either employers or insurers to administer HIV antibody tests is that test subjects will receive inadequate counseling in these contexts. Because AIDS is a deadly disease for which there is currently no known cure, receiving a positive HIV antibody test result is, at minimum, emotionally disturbing. Between 1985 and 1987, fifteen persons in Massachusetts committed suicide after learning that they had tested positive for HIV antibodies.[141] As the Massachusetts Insurance Commissioner has recognized, the HIV antibody test is "of such a sensitive nature and so far out of the ordinary that extensive counseling is [routinely] done before and after the tests."[142] According to the AIDS Health Project of the University of California, the results of a survey of approximately 1,000 persons who took the test at two San Francisco locations (one of which provided anonymous testing with comprehensive counseling), reveal that "providing free, voluntary, and anonymous testing with effective pre-test education, sensitive and responsible counseling, and effective referral to appropriate follow-up services . . . may play an important role in AIDS prevention."[143] Although several states offering voluntary testing do provide comprehensive counseling with the tests,[144] most insurance companies do not. Without adequate counseling, not only may employer or insurer administration of HIV antibody tests be imprudent, it may also be unethical.[145]

Employer and insurer inquiries into the results of HIV antibody tests taken prior to the application for a job or for insurance create a strong disincentive to be tested. Particularly among persons in high-risk groups, the suspicion of having been exposed to the HIV is likely to lead to test avoidance. Concern over disincentives to voluntary testing has already lead public health officials to reject a policy of widespread mandatory testing, even for persons most likely to spread the virus.[146] Given

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[141] Foreman, *Suicides Raise Questions on AIDS Testing*, Boston Globe, Feb. 14, 1987, at 17, col. 2.

[142] Kahn, *supra* note 82, at 17, col. 1.

[143] *See* Dlugosch, Gold & Dilley, *AIDS Antibody Testing: Evaluation and Counseling*, Focus, July 1986, at 1, 2.

[144] *See, e.g.*, Knox, *Specialists on AIDS Reject Mandatory Test*, Boston Globe, Feb. 25, 1987, at 1, 12, col. 6; Lambert, *Health Chief Warns AIDS Will Affect City*, N.Y. Times, Jan. 17, 1987, at 29.

[145] *See, e.g.*, Bayer, Levine & Wolf, *supra* note 44, at 1770, 1772–73.

[146] *See* Altman, *Need to Widen AIDS Testing Seen as Health Forum Ends*, N.Y. Times, Feb. 26, 1987, at 87, cols. 1–2. Some Reagan Administration officials apparently disagree. *See* Boffey, *Bush Favors Requiring AIDS Test For Marriage License Appli-*

that the Public Health Service has officially recommended that members of groups at high risk with respect to AIDS take the HIV antibody test,[147] insurer inquiries into prior test results appear directly to contradict public policy.

## IV. Costs and Benefits of Test-Use Prohibition

Deciding whether to prohibit employer and/or insurer use of the HIV antibody test or its results requires an evaluation of the relative merits of the arguments on both sides of the debate. An accounting of the costs and benefits associated with a prohibition must be made. The following section outlines these costs and benefits and discusses how they affect various social groups.

### A. *Costs*

#### 1. Potential Discrimination Against Certain Groups

Both employers and insurers, if barred from ascertaining the HIV antibody status of persons whose health care they insure, have an incentive to screen individuals on the basis of other, less specific, characteristics associated with groups at high risk with respect to AIDS. In particular, it is likely that this incentive could lead to discrimination against persons perceived as homosexual or bisexual. Only Wisconsin and the District of Columbia currently have statutes prohibiting employment discrimination on the basis of sexual orientation,[148] and it is still uncertain how many states will adopt regulations based on the NAIC's Medical/Lifestyle Questions and Underwriting Guidelines to prevent such discrimination in insurance. In either context, antidiscrimination laws may be very difficult to enforce. The costs of discrimination on the basis of proxies for HIV seropositivity could be high, both to the individuals affected and to society in general, particularly in the form of lost productivity.

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*cants*, N.Y. Times, Apr. 9, 1987, at B8, col. 5 (reporting that Vice President Bush favors mandatory testing of all couples applying for marriage licenses).

[147] N.Y. Times, Mar. 14, 1986, at A1, col. 3.

[148] D.C. Human Rights Act, D.C. Code Ann. § 1-2512 (1985); Wis. Stat. Ann. § 111.36 (West Supp. 1985). Approximately 50 cities also prohibit sexual orientation discrimination in employment. *See, e.g.*, New York, N.Y., Code Local Law 2 (1986); Philadelphia, Pa., Code § 99-1103(a)(1) (1985).

### 2. Increased Employer Liabilities and Possible Reductions in Employee Benefits

Both self-insured employers and employers offering employee benefits through insurance companies, if unable to screen employees for the presence of HIV antibodies, may seek to reduce the breadth of their benefit plans in order to avoid the potential liabilities associated with employees who develop AIDS. Although only self-insured employers must directly bear the costs of particular AIDS-afflicted employees, employers providing company-purchased insurance would eventually bear these costs in the form of higher premiums. Significant reductions in employer-provided benefits would force employees to seek adequate insurance on an individual basis. As discussed above, individual insurance is much more expensive, and for persons with high health risks also more difficult, to obtain.[149] Thus, an HIV antibody testing ban on employers could have disruptive consequences on the insured status of the great majority of persons who currently depend on employer-provided health care and other health-related benefits.

### 3. Increased Life Insurance Liabilities and Possible Loss of Life Insurance Policies

Because the vast majority of health insurance is purchased on a group basis without regard to individual health records, the insurance industry is unlikely to suffer serious financial losses due to a ban on the use of the HIV antibody test or of test results for health insurance purposes. With respect to life insurance, over fifty percent of which is purchased by individuals at premiums tailored to their personal morbidity and mortality risks, however, a testing ban could cause insurers to suffer significant financial losses. Faced with a large number of HIV seropositive persons engaging in the adverse selection of life insurance, certain insurers may consider such losses too great to bear. They may, as the District of Columbia experience indicates, completely cease to offer individual life insurance policies.[150] Thus, a ban on the use of HIV antibody tests by life

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[149] *See supra* text accompanying notes 99–101.
[150] *See supra* text accompanying note 119.

insurers could severely curtail the availability of private life insurance to the entire insurance-seeking population.

### B. *Benefits*

#### 1. Job Security for HIV Seropositives

Banning use of the HIV antibody test for employment purposes would benefit both HIV seropositive persons and society as a whole. Seropositives would retain jobs and their accompanying economic and insurance benefits, and society would avoid the costs of lost productivity and increased burdens on public welfare entailed in the potential unemployment of over a million seropositives. Judging from the estimated costs of lost productivity due to AIDS itself ($55.6 billion by 1991),[151] the social costs of employer screening for HIV seropositivity, a much more prevalent condition, could be enormous.

#### 2. Secured Confidentiality of Test Results

The wide-spread concern about test result confidentiality is closely related to the issue of job security. Potential disclosure of positive HIV antibody test results is one of the most frequently cited reasons for prohibiting use of the test by insurers, in large part because of the effect such disclosure might have on seropositives in the workplace.[152] Other possible effects of disclosure include discrimination in housing,[153] in credit,[154] and even in maintaining child visitation rights.[155] Unless the confidentiality of test results can be guaranteed, testing by insurers and employers may create additional costs associated with discrimination in a panoply of new contexts.

[151] Scitovsky & Rice, *supra* note 16, at 7.

[152] *See, e.g.*, Scherzer, *supra* note 127, at 21; Bayer, Levine & Wolf, *supra* note 44, at 173; J. LEVI & B. SCHATZ, AIDS-RELATED ISSUES AND INSURANCE 2-3 (position paper presented to the NAIC, Dec. 1986).

[153] *See* Kahn, *supra* note 82, at 19, col. 1.

[154] *See* Bayer, Levine & Wolf, *supra* note 44, at 173.

[155] *See* Boodman, *AIDS Discrimination Issue Mushrooming*, Washington Post, Nov. 24, 1986, at A1, col. 1.

3. Secured Private Insurance Coverage

Because most health insurance is provided on a group basis, insurer use of the HIV antibody test is more likely to affect the status of seropositives with respect to life, as opposed to health, coverage. The relative value of providing individual life, as opposed to health, coverage to seropositives is not, however, proportional to the number of individual insurance-seeking seropositives in each area. The principal benefits of securing private health insurance coverage for seropositives are guaranteeing them quality health care and avoiding additional burdens on publicly-provided care. With respect to life insurance, the principal benefits are securing benefits for seropositives' beneficiaries and avoiding additional burdens on public welfare programs. Seropositives deprived of private health care coverage will almost certainly depend on publicly-provided health care if they develop AIDS. Those who would be beneficiaries of AIDS victims, however, would not necessarily become dependent on public welfare programs if the latter could not obtain life insurance. From a social point of view, then, a ban on use of the test by health insurers is likely to reap more benefits than would such a ban on life insurers.

4. Reduced Disincentives for Voluntary Testing

Voluntary testing, accompanied by careful counseling, may play a critical role in stemming the spread of AIDS. Although a mere ban on the administration of the HIV antibody test by employers and insurers would not itself affect incentives to be tested voluntarily, a ban on employer and insurer inquiries into prior test results could significantly encourage voluntary testing.[156] In light of the recent consensus of the Centers for Disease Control that voluntary testing promises a more effective long-range solution to the spread of AIDS than mandatory testing,[157] the benefits of a ban on prior-test inquiries could be extremely significant.

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[156] *See supra* text accompanying note 140.

[157] *See* Altman, *supra* note 140, at A1, col. 4; Knox, *supra* note 144, at 12, col. 2.

### C. *Weighing Costs and Benefits*

Although it is impossible to quantify the costs and benefits discussed above with any degree of accuracy, it is possible to assess their relative significance for society as a whole. To make such an assessment requires a determination of which social groups bear which costs, and which groups enjoy which benefits. The distributional effects of a test-use ban may importantly influence the prohibition decision. For example, it may be optimal for the insurance industry to bear the cost burden of AIDS-related claims if the industry can pass those costs onto a nationwide group of relatively well-off policyholders. Table 1 summarizes the costs and benefits discussed above and indicates their effects on specific social groups.

## V. The Regulatory Decision

The following section suggests a regulatory compromise designed to maximize benefits and minimize costs within the limits imposed by considerations of distributional fairness.

### A. *Prohibit Employer and Insurer Inquiries into Results of Prior HIV Antibody Tests*

The strong interest in preventing the spread of AIDS counsels in favor of encouraging carriers of the HIV to discover their risk of transmitting the virus to others. In light of the recent conclusion of the Centers for Disease Control regarding the importance of voluntary testing, states should make every effort to reduce disincentives to be tested. Because both employer and insurer inquiries into the results of prior HIV antibody tests obviously create such disincentives, states should prohibit such inquiries.

### B. *Prohibit Employer Use of Test Results as a Criterion for Employability*

Asymptomatic HIV seropositivity bears little or no relationship to an individual's ability to perform a job. Because the HIV can be transmitted only through the exchange of bodily fluids,

**Table 1**
*Costs and Benefits of a Ban on HIV Antibody Testing*

| *Costs* | *Affected Group* | *Benefits* | *Affected Group* |
|---|---|---|---|
| | *Ban on Employer Testing* | | |
| Higher benefit liabilities | Employers | No lost productivity | Society |
| | | No increased unemployment | Society |
| Reduction in employee benefits? | All employees | No increased public health care burden | Society |
| Discrimination against groups perceived as high-risk? | Perceived high-risk groups | Protected confidentiality of test results | Seropositives |
| | | Increased voluntary testing* | Society |
| | *Ban on Health Insurer Testing* | | |
| Higher benefit liabilities | Insurers | No increased burden on Medicaid and other public health programs | Society |
| Loss of individual policies? | Insured population | Protected confidentiality of test results | Seropositives |
| | | Increased voluntary testing* | Society |
| | *Ban on Life Insurer Testing* | | |
| Higher benefit liabilities | Insurers | Fewer beneficiaries dependent on public welfare? | Society |
| Loss of individual policies (?) | Insured population | Protected confidentiality of test results | Seropositives |
| | | Increased voluntary testing* | Society |

*Increased voluntary testing will be achieved if employers and/or insurers are prohibited from inquiring into the results of prior tests.

medical experts have concluded that there are relatively few, if any, risks of its transmission in the workplace. Although the HIV antibody test can indicate a future risk of inability to work, at best it predicts a fifty percent chance that an individual will develop a disabling AIDS-related condition within a minimum of five years.[158] Given that the laws of many states 1) already treat AIDS and its related illnesses as handicaps for purposes of employment discrimination,[159] and 2) permit denials of employment based on the risk of future illness only when this risk is demonstrably high,[160] it would seem anomalous to consider HIV seropositivity as a valid basis for employment discrimination.

Efficiency also counsels in favor of anti-discrimination legislation: considering the high indirect costs of AIDS, whose victims represent only a portion of the large and growing HIV seropositive population, anti-discrimination legislation could conceivably prevent $55.6 billion in lost productivity in 1991.[161] Both the law and the goals of economic efficiency, then, support the argument for either adopting a prohibition on the use of HIV antibody test results as a criterion for employability, or officially declaring HIV seropositivity to be a handicap for purposes of employment discrimination law.

### C. *Prohibit Insurer Use of Test Results as a Criterion for Health Insurability*

The costs of a ban on health insurer use of either the HIV test or test results are, due to the large proportion of group health coverage, relatively low. The benefits of such a prohibition, as stated above, consist of secured quality health care for seropositives and the avoidance of additional health care burdens on public services. The latter benefit is particularly significant from a distributional perspective, particularly with respect to those seropositives who do develop AIDS. First, because AIDS appears to be highly concentrated within a few states, burdening public welfare programs with additional AIDS-related costs will disproportionately, and arguably unfairly, affect these

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[158] *See supra* text accompanying note 11.
[159] *See supra* text accompanying note 59.
[160] *See supra* text accompanying note 96.
[161] *See supra* text accompanying note 19.

few states. Second, within these states, those municipalities offering adequate health care to AIDS patients will bear a disproportionate burden of increased public health care costs. The alternative of spreading the health care costs of seropositives among the national insured population is the more equitable choice.

### D. *Permit Insurer Use of Test Results as a Criterion for Life Insurability Under Strict Regulatory Conditions*

Although the insurers' fairness arguments for permitting insurers to use HIV seropositivity as a criterion are unpersuasive regarding health insurance, these arguments carry more weight with respect to life insurance. Unlike health insurance, most life insurance is purchased on an individual basis, at premiums tailored to the mortality risks of the policyholder, and thus HIV antibody screening has more impact in the life insurance context than in the health insurance context. As the District of Columbia experience suggests, the financial losses caused by banning life insurer use of the HIV antibody test could be great.

Although denying life insurance to HIV seropositives clearly deprives their beneficiaries of important benefits, the costs of this deprivation, both for those beneficiaries and for public welfare programs, must be weighed against the harm a test-use ban would cause to all persons seeking individual life insurance. Such a ban would effectively discriminate against members of the population whose health risks, other than AIDS, place them in a high-premium paying bracket. In addition, if the threat of adverse selection by seropositives and the consequent risks of AIDS-related liabilities is as significant as the District of Columbia experience suggests, a test ban could potentially deprive all persons of individually-provided insurance.

If states do choose to permit insurers to use the HIV antibody test to determine eligibility for life insurance (or indeed, for any purpose), they should adopt strict regulatory guidelines for test administration and subsequent handling of test results. These guidelines should include:

1. Non-discriminatory test administration:

Insurers must justify any selective testing of applicants on the basis of objective criteria supported by valid statistical and medical evidence. In particular, selection may not depend on stereotypical characteristics associated with groups at high risk of developing AIDS.

2. Prior, written, informed consent of applicants:
Prior to testing, insurers must provide applicants with full information regarding the nature of the test, its reliability, and the implications of its results. No test shall be administered until the applicant, having received this information, consents to the test in writing.

3. Laboratory standards:
All testing must conform to standards established by the Department of Public Health of the state where the test is administered. No ELISA test result shall be considered indicative of positive HIV antibody status without confirmation through a positive result on a Western Blot or equally reliable test.

4. Counseling:
Any applicant whose test results are confirmed positive must receive comprehensive counseling. This counseling should include scientific and medical information about AIDS and its related conditions. In particular, it should focus on transmission of the disease through the HIV. Guidance on preventing transmission should include discussion of safe sex and other means of avoiding the exchange of bodily fluids. In addition, the counselor should supply the names of contacts to provide follow-up counseling and support groups.

5. Confidentiality:
Insurers must keep all test results absolutely confidential. This mandate requires not only preventing the exposure of test results outside of the company administering the test, but also strictly limiting access to test results within that company. Intracompany confidentiality will be especially critical if a state, as is recommended, prohibits use of test results as a criterion for health insurability. Companies that offer both life and health insurance must not allow their health insurance divisions access to test information. Exchanges of test information between companies must similarly be barred, and neither test results nor information such as the refusal to be tested should be available

to the Medical Information Bureau. All confidentiality requirements must also apply to other extra-company contacts.

6. Enforcement:
In order to ensure compliance, the state should strictly enforce the above standards under threat of civil and criminal sanctions. The state's insurance commissioner should ensure consistent oversight of company test administration as well as the handling of test results.

## VI. Beyond the Testing Decision: Dealing With the Costs of AIDS

Whether or not states choose to prohibit the use of the HIV antibody test by employers, insurers, or both, they should aim both to reduce and to allocate fairly the costs associated with AIDS. Such efforts may help to alleviate the pressures on employers and insurers to discriminate against HIV seropositives, thereby achieving some of the objectives of a testing or test result-use ban.

### A. *Cost Reduction*

#### 1. Direct Costs

As discussed above in Part I, estimates of the direct personal medical care costs of AIDS vary widely.[162] Much of this variation is attributable to different assumptions about the number of days that AIDS patients must spend in the hospital from the onset of illness until death. Early studies did not account for the fact that many AIDS patients may successfully receive treatment at home or in hospices.[163] Several states have already made attempts to facilitate such treatment. New Jersey, for example, recently obtained a waiver from the Department of Health and Human Services permitting the state to receive Medicaid reimbursement for AIDS patients treated at home. Under the waiver, New Jersey will be able to provide home and community-based services that AIDS victims otherwise could obtain only in an

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[162] *See supra* text accompanying notes 13–19.
[163] *See* Fox, *supra* note 12, at 25.

institution at a much higher cost.[164] State endorsement of home and hospice treatment for AIDS patients could lead to cost reductions not only in publicly funded care, but also in care covered by private insurance. If so, this policy could help to reduce employer and insurer incentives to discriminate against all victims of AIDS, including asymptomatic seropositives and persons perceived to be in high-risk groups.

#### 2. Indirect Costs

As emphasized above, the most effective way to reduce the indirect costs of AIDS is to prevent discrimination against all AIDS victims, symptomatic or not, in the workplace. Even without adopting the provisions recommended above, states can take steps to prevent such discrimination by explicitly supporting the general consensus that AIDS and ARC constitute handicaps for purposes of employment discrimination laws.

### B. *Cost Allocation*

Fair distribution of AIDS-related costs is, and probably will continue to be, a controversial issue. However, as one commentator has remarked regarding the distributional effects of the choice between permitting or prohibiting testing, "[e]ither way, the public will end up picking up [the AIDS victims'] health care tab, if not through higher insurance premiums, then through welfare programs and, ultimately, higher taxes."[165] Given the fact that our society has not chosen a system of widespread publicly-provided health care, states must aim for a fair distribution of health care costs within the constraints of a predominately private market.

#### 1. State Health Insurance Pools

In response to the problem of uninsurability of individuals with high health risks, at least fifteen states have established insurance pooling mechanisms that enable such persons to ob-

[164] *See HHS Grants Waiver*, *supra* note 26, at 7. Massachusetts will provide $240,000 in 1987 and $400,000 in 1988 to eight hospice agencies that offer home care for AIDS patients. N.Y. Times, Jan. 6, 1987, at B6, col. 5.

[165] Tuller, *supra* note 35, § 3, at 8, col. 1.

tain private health insurance coverage.[166] These states require all insurers, as a condition of operating in the state, to belong to a state organization, usually called the state "Comprehensive Health Insurance Association,"[167] or the "Health Reinsurance Association."[168] This organization offers health insurance covering most major medical expenses to persons who have applied for and been denied coverage at one or more of the participating insurance companies. Generally, this insurance is provided at rates between 125 and 200 percent of the standard premium rate charged in the state.[169] Because such organizations must, by law, agree to cover the health care costs of persons whose health risks prevent them from obtaining private coverage elsewhere, they may provide an important means for AIDS or ARC victims, whom insurers justifiably deem uninsurable, to avoid reliance on public health care programs. Of course, the ability of AIDS and ARC patients to take advantage of state insurance pools depends on their ability to pay the high pool premiums, and thus a considerable number of AIDS patients, particularly intravenous drug users, may not benefit from these pools. As the disease spreads, however, state health reinsurance organizations may play a critical role in distributing the costs of the disease.

If states do not choose, as is recommended, to prohibit insurer reliance on HIV seropositivity as a criterion for health insurance coverage, HIV seropositives, like persons with AIDS or ARC, will join the group of uninsurables in each state. The insurance industry, advocating its own testing, supports the establishment of state insurance pools as a means of offsetting the costs of this testing both to seropositives and to public health care programs.[170]

The industry qualifies its support for pooling, however, on the condition that self-insured employers belong to the health reinsurance organizations. On the assumption that such organizations sustain losses, the insurance industry predicts that their establishment encourages employers to self-insure, rather than to purchase benefit plans through insurance companies, in order to avoid pool assessments and increased premium taxes. Cre-

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[166] Pear, *States Act to Provide Health Care Benefits to Uninsured People*, N.Y. Times, Nov. 22, 1987, § 1, at 44, col. 1.

[167] *See, e.g.*, IND. CODE ANN. § 27-8-10-1 to -8 (Burns 1986); MINN. STAT. ANN. § 621.02 (West 1986).

[168] *See, e.g.*, CONN. GEN. STAT. ANN. § 38-376 (West 1987).

[169] *See* statutes cited *supra* notes 167–68.

[170] *See* HIAA-ACLI Statement to the NAIC, *supra* note 108, at 14.

ating this incentive is unfair, the insurers argue, in that it effectively burdens the insurance industry with a disproportionate share of the social costs of uninsured persons.[171]

Because ERISA, not state law, governs the employee benefit plans of self-insured employers, states cannot mandate that self-insured employers participate in insurance pools. Such a mandate would have to come from Congress. In the 99th Congress, Representative Barbara Kennelly (D-Conn.) introduced a bill that, if enacted, would have imposed a federal tax on self-insured employers who did not voluntarily participate in state health insurance pools.[172] The bill failed to pass in the House of Representatives. Nevertheless, states should not hesitate to establish a state pooling organization. Rather, they should take steps toward creating such organizations, in anticipation that insurers will successfully lobby for legislation compelling self-insured employers to participate in them once they are formed.

### 2. Public Health Care Funding

In order to reduce the costs of providing health care for AIDS patients, states should encourage funding for home and hospice care as an alternative to hospital care. This policy will have allocative as well as cost-reduction benefits. Because AIDS patients are heavily concentrated in a few municipalities, a disproportionate share of AIDS-related health care costs tends to fall on the few city hospitals that treat these patients.[173] The state should combat such distributional unfairness through direct subsidies to the city hospitals that bear the brunt of the AIDS cost burden.

## VII. Conclusion

The legal and policy concerns inherent in the HIV screening issue have prompted several states to question the use of the HIV antibody test or its results by employers and/or insurers. This Comment's four-part legislative solution to the screening

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[171] *See id.*

[172] *See* H.R. 1770, 99th Cong., 1st Sess. (1985). The declared purpose of the proposed law was, in part, to "provide incentives for participation [in state insurance pooling mechanisms] by all private health care financing mechanisms including self-funded employee health benefit plans." *Id.* at 2.

[173] *See, e.g.*, Scitovsky & Rice, *supra* note 16, at 16.

problem suggests that states should 1) prohibit both employers and insurers from inquiring into the results of past tests taken by applicants; 2) either prohibit employers from using the HIV antibody test as a determinant of employability or declare HIV seropositivity a handicap for purposes of handicap discrimination laws; 3) prohibit insurer use of the test as a criterion for health insurability; and 4) permit insurer use of the repeated ELISA and Western Blot (or a test of comparable or superior reliability) to determine eligibility for life insurance only under strictly enforced standards. The test administration standards suggested for life insurers should similarly apply to any state law-governed organization that undertakes an HIV antibody testing program.

In addition to adopting this particular testing and test-inquiry ban, states should attempt to reduce and allocate fairly the social costs of AIDS within the state. This entails 1) the establishment of mandatory health insurance pooling organizations; 2) the provision of state funds for home and hospice, as well as hospital AIDS-related care; and 3) the subsidization of municipal hospitals burdened with significant AIDS-related costs. Finally, states should seek long-term solutions to AIDS-related problems by providing comprehensive public education about the disease and its transmission and by administering free, confidential HIV antibody testing and extensive counseling to those who seek it. In this way, the states can make a necessary and important contribution to reducing their own, the national, and indeed the world-wide social and economic costs of AIDS.