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THE LAWYER AS LITIGATOR IN THE 1980s

Mary Kay Kane*

I. INTRODUCTION

Trends in litigation often take a generation or more to be identified, so long-range forecasting can be risky. Still, there are some distinct and observable changes in civil litigation practices that began in the late 1970s and are coming into their own in this decade of the 1980s. Although comparable pressures are being exhibited in some state courts, these trends are more

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1. My focus on civil litigation is not to suggest that criminal litigation practices are immutable. Changes there appear primarily in the shifting availability of defenses as a result of standards imposed on police through the Fourth and Fifth Amendments. See Bradley, Two Models of the Fourth Amendment, 83 Mich. L. Rev. 1468 (1985); Grano, Prophylactic Rules in Criminal Procedure: A Question of Article III Legitimacy, 80 Nw. U.L. Rev. 100 (1985). However, the tasks and role of the criminal trial lawyer have not received much attention outside of the area of ethical responsibilities to the client and the court. See Nix v. Whiteside, 475 U.S. 157 (1986). An explanation for why criminal litigation trends are not paralleling the civil side may be found, at least in part, in the fact that constitutional impediments there have prevented some of the very reforms that are occurring on the civil side. The obligations of civil counsel of disclosure, candor and cooperation, which are discussed later in this piece, are, if anything, prohibited by the constitutional protections afforded the accused.

2. In response to problems in the discovery arena, a number of states now limit the number of interrogatories without leave of court. See, e.g., Minn. C.P.R. 33.01(1) (limiting interrogatories to fifty, without leave of court, and counting each subdivision as a separate question). The California Judicial Council has approved lists of standard interrogatories. Appendix to Cal. Civ. Pro. Code § 2036.5 (approved Jan. 1, 1983). New York requires a choice in wrongful death actions between interrogatories, bills of particulars or depositions. Although interrogatories always are permitted, the other two may be used only upon motion. N.Y. C.P.L.R § 3130 (McKinney Supp. 1986).

States also have been at the forefront in revising their class action statutes to better accommodate that litigation. See, e.g., N.Y. C.P.L.R §§ 901-908 (McKinney 1976); N.D. Rules of Civ. Proc., Rule 23; and R.I. Rules of Civ. Proc., Rule 23.

More generally, the increasing number of state laws and cases involving sanctions for attorney abuses may be seen as paralleling federal court developments discussed infra at notes 51-125. See Parness, Grounding Groundless Papers, 25 Judges Journal 9 (1986).
readily visible in the federal courts because of the wealth of reported experience there. So I will restrict my examination to that system, noting that, as has been true with so many procedural movements, it is likely that much of what occurs in the federal arena will soon be mirrored in the states.

Litigation trends are examinable from many perspectives and for varying purposes. For example, what is the impact of litigation practices on our notions of justice? Or, as judges see it, what is happening to the courts themselves as a result? In fact, a few before me have made these inquiries. I propose to take yet a different path and to scrutinize the impact of these alterations on the lawyers who inhabit the litigation arena.

My purpose is not to comment on why litigation practices are changing so radically and so recently. You have seen the signs of that change as well as I. Neither is it my intention to pass judgment on the qualities of the “modern” litigator. Instead, I propose to explore the ways in which present day litigators must change their practices, and, even more importantly, some of their basic attitudes. A parallel inquiry will be how courts are forging this transformation.

Judges wield enormous power. However, the success or failure of current efforts to improve the delivery of the American dream of efficient, economical justice lies with the lawyers who people the courts. Litigating lawyers must take the initiative. They must begin to recognize the ways in which their practices can and should be altered so as to better promote the objective we share as professionals and our society so profoundly desires. Unfortunately, the very nature of litigation seldom affords these frontline soldiers the opportunity for reflection. So, capitalizing on the distance that allows me a panorama and an academic perspective that day-to-day participants rarely can obtain, I offer my observations and suggestions with the hope that they will provide a fruitful starting point for some self-examination.

II. BACKGROUND

To appreciate fully the current state of civil litigation practice, it is necessary to look briefly at some procedural history. Begin-

3. For example, a majority of states have adopted notice pleading provisions virtually identical to those used in the federal courts. J. FRIEDENTHAL, M. KANE & A. MILLER, CIVIL PROCEDURE § 5.1 at 238 n.14 (1985). Even more popular have been the federal discovery rules, which have been widely copied. Id. at § 7.1.
ning in 1938, the effective date of the original Federal Rules of Civil Procedure, until the current decade, the general trend in the federal courts has been to abjure rigid rules in favor of opening access to the courts and encouraging the exchange of information between adversaries before trial. The trial is not to be a game of wits; it is to be an open, but adversarial, proceeding in which, after full disclosure, the participants are able to present their cases to the trier of fact for resolution. This desire for increased and easier court access to resolve disputes was a reaction to the rigid system that had developed under code pleading utilized in most states and therefore by the federal courts under the Conformity Act. The 1934 Rules Enabling Act gave the Supreme Court the power to promulgate its own procedural rules for the federal courts and the first set embodying these changes became effective in 1938. The thrust of the federal civil rules is captured in the first rule, which provides that "[t]hey shall be construed to secure the just, speedy, and inexpensive determination of every action."

A brief look at some of the specific procedural innovations adopted in 1938 is useful because it gives some perspective on litigation today. The first matter of particular note is pleading: the federal rules adopted what is referred to as "notice pleading." No longer was it necessary to set out detailed facts

5. "The basic purpose of the Federal Rules is to administer justice through fair trials, not through summary dismissals as necessary as they may be on occasion. These rules were designed in large part to get away from some of the old procedural booby traps which common-law pleaders could set to prevent unsophisticated litigants from ever having their day in court. If rules of procedure work as they should in an honest and fair judicial system, they not only permit, but should as nearly as possible guarantee that bona fide complaints be carried to an adjudication on the merits." Surowitz v. Hilton Hotels Corp., 383 U.S. 363, 373 (1966). See 4 C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE: CIVIL § 1029 (1969).
10. For a description of the history and reasons behind those innovations, see Clark, The Handmaid of Justice, 23 WASH. U.L.Q. 297 (1938).
supporting a claim or defense in order to survive an early motion to dismiss or to strike. Instead, all that was required was for the pleader to provide sufficient allegations to allow the opposing party to understand what the claim was about. In addition, detailed rules of discovery were promulgated to encourage the exchange of information prior to trial. Given this increased access, summary judgment procedures also were included to permit the early disposition of cases when the information discovered revealed that there was no genuine issue of material fact and that the moving party deserved judgment as a matter of law. Finally, a series of joinder rules were included that allowed the courts to expand the number of parties and claims that could be adjudicated in a single action.

The general trend reflected in amendments made to the Federal Rules of Civil Procedure since 1938 has been to facilitate even further the goals of that original set of Rules. In 1966 substantial amendments were made to all the party and claim joinder rules, designed to facilitate easier and broader joinder in federal litigation. In 1970 a complete overhaul was made of the

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12. "The Federal Rules reject the approach that pleading is a game of skill in which one misstep by counsel may be decisive to the outcome and accept the principle that the purpose of pleading is to facilitate a proper decision on the merits." Conley v. Gibson, 355 U.S. 41, 48 (1957). See generally 5 C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE: CIVIL §§ 1215-1216 (1970).


14. FED. R. CIV. P. 56.

15. FED. R. CIV. P. 13-14, 17-25.

16. Although it is outside the trend discussed in the text, it is worth noting that in 1963 amendments were made to Rule 56, governing summary judgments. The party opposing such a motion cannot merely rest on the pleadings; once the moving party has presented sufficient evidence to suggest that judgment is warranted, the opponent must come forward with sufficient evidence to rebut that conclusion. Fed. R. Civ. P. 56(e). See Advisory Committee Note to the 1963 Amendment to Rule 56(e), reprinted in 31 F.R.D. 648; Kaplan, Amendments of the Federal Rules of Civil Procedure, 1961-1963 (II), 77 HARV. L. REV. 801, 825 (1964). In this way litigators were encouraged to use summary judgment to prevent baseless claims from going forward; the procedure became a most useful tool to pierce the pleadings and assess the proof. See generally 10 C. WRIGHT, A. MILLER & M. KANE, FEDERAL PRACTICE AND PROCEDURE: CIVIL 2D § 2712 (1983).

federal discovery rules. Open exchange of information was encouraged further by removing from many of the rules the requirement that parties receive court permission to have access to certain information; discovery was to proceed primarily by and through the parties, with court intervention only when an impasse was reached. The sole addition that might be seen to limit pretrial access was the introduction into the rules of protections against disclosure of attorney work-product. But that addition merely codified the governing law imposed on the federal courts by the Supreme Court in *Hickman v. Taylor* in 1947, and thus cannot be seen as any kind of retreat from the general trend I am describing.

Although other amendments have been made to the federal rules during the past forty years, the two I have highlighted are most important, for they express a philosophy about litigation that seeks both to encourage resort to the courts to resolve disputes, by making that choice easier to accomplish, and to expand the contours of litigation in the belief that larger lawsuits will produce judicial economy and efficiency.

It is important to note briefly two other major developments that also occurred during this same forty year period, for they have serious bearing on the state of civil litigation today. The first is that throughout this time there has been a continuing codification of new rights enforceable in the federal courts, as well as the passage of more and more detailed federal regulations governing various activities of our lives. In addition, business
relationships and areas have expanded so that it now is commonplace to have complex nationwide, or international, transactions. Necessarily, all of these developments have provided increased opportunities for litigation, whether to resolve disputes when breakdowns occur or to interpret and apply new regulatory frameworks. The procedural amendments just described facilitated markedly the ability of persons affected by these developments to appeal to the courts for a resolution of their disputes; simultaneously, the importance of the lawyer's role as a litigator was enhanced.

III. Litigation in the 1980s

So what have these developments produced in the 1980s? The most obvious fact is that the federal courts are now terribly overcrowded, resulting in delays for all litigants. The impact of this phenomenon was stated succinctly by the Supreme Court in *Roadway Express Inc. v. Piper,* when it said: "The glacial pace of much litigation breeds frustration with the federal courts and, ultimately, disrespect for the law."29

Along with this overcrowding have come disquieting allegations about the tactics and practices of the attorneys appearing before the courts. Myriad articles in bar association journals assert that many litigators have become lax in preparing their cases,

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26. The impact of these new opportunities is reflected in the statistics on cases filed in the federal courts in the last twenty years. For example, in 1964 the total number of civil cases filed in the federal courts was 66,930; in 1974, it was 103,500; and in 1984, it was 261,485. Similar growth patterns are reflected in the statistics for suits filed to enforce some of the new statutory rights of the 1960s. Statutory civil rights cases provide a good example. In 1964, only 709 statutory civil rights actions were filed; in 1974, the number was 8,443; and it more than doubled by 1984, when 21,219 such suits were filed. See Annual Report of the Director of the Administrative Office of the United States Courts, 1964, 1974, and 1984. See also Want, *The Caseload Monster in the Federal Courts,* 69 A.B.A. J. 613 (1983).


29. Id. at 757 n.4. See also Burger, *Isn't There a Better Way?,* 68 A.B.A. J. 274 (1982).

or even that litigation practices today reveal increased lawyer incompetence. With the expanding nature of substantive rights has come a seeming flood of claims testing the boundaries of these new rights.\textsuperscript{31} Although many of these suits are necessary and proper, others that are filed clearly are frivolous, allowed only because of our liberal notice pleading, which does not permit the early screening of cases.\textsuperscript{32} Critics have bemoaned that summary judgment has not been fulfilling its needed role to weed out cases and avoid unnecessary trials.\textsuperscript{33} Charges also have been lodged that the open-ended discovery process promoted by the rules has become the subject of abuse, by plaintiff and defense counsel alike,\textsuperscript{34} and calls for reform have been made within the bar itself.\textsuperscript{35}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{32} There is an indication that, at least in some areas, the courts are placing greater burdens on plaintiffs, requiring what is essentially fact pleading in order to ensure that a viable claim does exist. See Brunet & Sweeney, \textit{Integrating Antitrust Procedure and Substance After Northwest Wholesale Stationers: Evolving Antitrust Approaches to Pleadings, Burden of Proof, and Boycotts}, 72 VA. L. Rev. 1015, 1067–74 (1986); Marcus, \textit{The Revival of Fact Pleading Under the Federal Rules of Civil Procedure}, 86 Colum. L. Rev. 433 (1986); Wingate, \textit{A Special Pleading Rule of Civil Rights Complaints: A Step Forward or a Step Back?}, 49 Mo. L. Rev. 677 (1984).
\item In 1986 the Supreme Court decided three summary judgment cases and at least one view of those decisions is to suggest that summary judgment should be more readily available in order to avoid the unfairness of unnecessary trials. See Celotex Corp. v. Catrett, 106 S. Ct. 2548 (1986); Anderson v. Liberty Lobby, Inc., 106 S. Ct. 2505 (1986); Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 106 S. Ct. 1348 (1986).
\item \textsuperscript{35} See the two reports of the Section of Litigation, American Bar Association Special Committee for the Study of Discovery Abuse. The October 1977 report is reprinted in 92 F.R.D. 149 (1982); the November 1980 report is reprinted in 92 F.R.D. 137 (1982); See also Brazil, \textit{The Adversary Character of Civil Discovery: A Critique and Proposals for Changes}, 31 Vand. L. Rev. 1255 (1978). For a report challenging the notion that discovery is one source of cost and delay, see Trubek, Sarat, Felstiner, Kritzer, Grossman, \textit{The Costs of Ordinary Litigation}, 31 UCLA L. Rev. 72, 89-90 (1983).
\end{itemize}
\end{footnotesize}
On top of all this easy access, the availability of class action relief to pursue these new claims also has precipitated a new form of nationwide litigation. At its worst, litigators in that arena are portrayed as promoting inefficient or frivolous litigation because the attorney fee stakes are so high that self-interest leads them on. But even with the highest ideals and motives, litigating class actions has placed new demands on the bar, both in terms of the complexity of the proceedings with which lawyers must deal and in terms of the difficult ethical problem of representing the named class representative and at the same time all those unnamed and absent class members. Viewed most harshly, these developments seriously challenge the original notion that “bigger lawsuits” are better because they are more economical. Less dramatically, they present the question whether there is not some breakpoint where bigger becomes too big.

No doubt some of these problems have existed since the very beginning of the federal court system. However, it is the flood of litigation and the modern complexity of society that has brought us to a crisis stage; that is, to a stage at which serious attention is being given to finding some solutions.

The two premises underlying the original civil rules and subsequent amendments—that it is desirable to promote access to the courts so that disputes may be resolved, and that it is equally important to encourage broad joinder to achieve judicial economy— are seriously at issue at this time. Arguments for tighter judicial management represent just one reaction to this problem. The starkest challenge to these premises and to what has been the traditional role of the civil litigator may be seen in the intense pressure to further develop and to utilize alternative dispute resolution devices, in other words, to stop using the

37. See, e.g., Diamond, Lawyers Sue to Keep Bhopal Clients, 131 CHI. DAILY L. BULL., April 4, 1985, at 1, col. 5; Meier, Lawyers for Victims of Bhopal Gas Leak Fighting One Another, Wall St. J., May 1, 1986, at 1, col. 6.
courts as the major means of solving civil disputes. Courses in alternative dispute resolution and in the skills training necessary to make use of arbitration, mediation and negotiation as methods of resolving disputes are becoming commonplace in law schools. A system of mandatory arbitration is being tried in several federal district courts for cases under $100,000 in the hopes that cases will be resolved satisfactorily there, avoiding the need for a trial. These are just a few of the developments happening in the ADR world.

Of course, resort to alternatives does not really address the problems facing the modern litigator, it merely changes the forum in which a dispute is presented and requires some specialized skills that perhaps were not seen as central to the litigator of yore. ADR is an approach, however, that does seem a flight from the original and continuing procedural changes that have been made to the federal rules and that were designed to encourage access to the courts.

But not all attention has been focused on how to get people out of court. Considerable effort has been made to identify ways to change some of the current litigation practices and thereby cure some of the ills resulting from them. Necessarily, these changes, if they are to succeed, will alter the role of, or at least

41. See generally A Selected Bibliography, Alternative Methods of Dispute Settlement, Compiled by the Special Comm. on Alternative Means of Dispute Resolution, American Bar Association (May, 1982).


44. See Fiss, Against Settlement, 93 YALE L.J. 1073 (1984). Perhaps this retrenchment should not be considered too startling. As noted by Professor Resnick, "The history of procedure is a series of attempts to solve the problems created by the preceding generation's procedural reforms." Resnick, Tiers, 57 S. CAL. L. REV. 837, 1030 (1984).

the methods employed by, litigators today. And no one can seriously doubt that changes are necessary.

There are many areas that might illustrate the kinds of developments taking place in the 1980s. For example, in the class action field where the very volume and complexity of the litigation filed in the 1970s challenged the philosophy pervading the Federal Rules that judicial economy is best achieved by the liberal joinder of claims and parties, there is as of yet no formalized or uniform response to this dilemma. However, in this decade of the 1980s, the courts are beginning to grapple with solutions for the problems facing the lawyers in these suits, and a review of some of these attempts presents one opportunity for a fruitful assessment of the 1980 litigator. Time will not permit me to explore those details here.

Instead, I intend to focus on a more general illustration of the kind of retooling that is ongoing and that also clearly reveals some rethinking about the early premises regarding the role of courts as dispute resolvers and on the proper role of the litigators before them. These developments involve the changing obligations of counsel in preparing their cases and in utilizing discovery to promote full disclosure. Here, change is being spurred by the courts in the form of amendments to the Federal Civil Rules. When lawyers and judges complain enough, the Rules respond.

In 1983 a series of amendments were made to several of the Federal Rules. Some of the changes made were designed to curb discovery abuses by authorizing the courts to limit discovery and impose sanctions in situations in which it is found that discovery is becoming "unreasonably cumulative or duplicative" or "unduly burdensome or expensive." Signalling a shift in attitude from earlier years, the title of former Federal Rule 26(a), now Rule 26(b)(1), was changed from "Scope of Discovery" to "Discovery Scope and Limits." Prior to that time, the Rule read that the frequency of discovery was unlimited unless the court entered a protective order; that had established a clear presumption that discovery was totally open ended. The 1983 amendments place new restrictions on discovery that clearly had gotten out of

control and implicitly acknowledge that discovery cannot be self-operative. Amended Rule 26(b)(1) expressly provides for limiting the frequency of discovery, but avoids what some states have attempted — statements of precise maximum numbers. Additionally, Rule 16 was rewritten to encourage the courts to exercise significant management of cases during the pretrial phase of the litigation, to prevent the kinds of delays that marked the 1970s. Finally, and perhaps most broadly significant, Rule 11, governing the signature of pleadings was amended to include new provisions increasing the obligation of attorneys to engage in prefiling inquiries, and making obligatory on the courts the imposition of sanctions for noncompliance.

The thrust of the 1983 amendments is to recognize that lawyer behavior must be more responsible and that the courts must be given the tools needed to deter marginal activity and to control overzealous or underresponsive conduct. Since these amendments, the courts' review of attorney conduct under their Rule 11 authority has flowered. Thus, the time has arrived to take a close look at what has been occurring there, for it permits some important insights into how the role of the litigator has changed or is changing in this new era.

IV. RULE 11: ATTORNEY RESPONSIBILITY AND SANCTIONS

Amended Federal Rule 11 was designed to encourage judges to police the members of the bar who overused, misused or abused the litigation process. To accomplish this objective, the rulemakers made three changes. First, they expanded the existing signature requirement to encompass all papers filed during the course of litigation. Second, they gave important content to

50. See infra text accompanying notes 51-125.
51. Prior to 1983, a signature requirement appeared in Rule 11, but that rule applied only to pleadings filed in the action; under the Rules there usually are only two documents properly called pleadings. The amendments expanded the coverage of that Rule to encompass "every pleading, motion, and other paper," included in an express cross-reference to this signature requirement in Rule 7(b)(3), dealing with motions and other papers, and added a new section to the discovery rules, Rule 26(g), requiring all discovery requests, responses or objections to be signed and certified.
this certification by providing that the signer is asserting that the paper has an adequate legal and factual basis, that it is not interposed for an improper purpose and, most importantly, that this conclusion has been reached after a reasonable inquiry. Third, sanctions are made mandatory under the Rule if a violation of the standard is found. Although the type of sanction remains within the trial judge's discretion, the amended Rule provides specific authorization for the award of attorney fees and costs resulting from any paper filed in violation of the Rule, and also recognizes that the court may impose sanctions on the client, the attorney, or both.\footnote{52. The provision for mandatory sanctions, including attorney fees, has been challenged as a substantive regulation that is potentially outside the scope of the Rules Enabling Act. See Burbank, \textit{Sanctions in the Proposed Amendments to the Federal Rules of Civil Procedure: Some Questions About Power}, 11 \textit{Hofstra L. Rev.} 997 (1983).}

Before turning to what these changes mean for litigators, it is worth noting the stated purpose of the amendments, as well as some statistics indicating how the courts have responded in the short time during which they have been operative. To begin with, the notion that frivolous claims and defenses should not be filed and that attorneys should investigate their cases before going to court most certainly is not novel. The original Federal Civil Rules contained a signature requirement to the effect that the signer warranted that the pleading was filed in good faith and not interposed to harass the opposing party.\footnote{53. \textit{FED. R. Civ. P. 11}. See 5 C. WRIGHT & A. MILLER, \textit{FEDERAL PRACTICE AND PROCEDURE: CIVIL §§ 1331-1333 (1969)}.} Further, sanctions always have been available under various statutes for filing frivolous claims and appeals.\footnote{54. See, e.g., 28 U.S.C. § 1927, and \textit{FED. R. App. P. 38}.} The key to understanding amended Rule 11 lies in its requirement that certification is to take place only after a reasonable inquiry. Under the prior Rule, most courts had held that sanctions were appropriate only when the counsel or party had acted in subjective bad faith in signing the pleading, and this high standard resulted in few violations being found.\footnote{55. See \textit{Risinger, Honesty in Pleading and its Enforcement: Some “Striking” Problems with Federal Rule of Civil Procedure 11}, 61 \textit{MINN. L. REV.} 1 (1976).}

As recognized by all the courts of appeals that have ruled on the question, the reasonable inquiry requirement is designed to impose an objective standard on this process.\footnote{56. \textit{See Eastway Construction Corp. v. City of New York}, 762 F.2d 243, 252 (2d Cir.)} In addition, that
objective standard now is to be applied not merely to the pleadings but to all papers filed in the action. The inclusion of a new signature requirement in Federal Rule 26(g) extends the same standard to papers and requests made in the discovery process.\(^{57}\)

But what does it mean to change from a subjective to an objective standard? The first and most obvious effect is that a much greater range of conduct now will come within the purview of the courts.\(^{58}\) As described by Professor Arthur Miller, the Reporter for the Advisory Committee which drafted the current Rule, this shift is designed to encourage greater care on the part of the bar.\(^{59}\) To paraphrase some remarks made by then Chief Justice Burger: “Your signature on a pleading or motion is something like your signature on a check. There is supposed to be something to back it up.”\(^{60}\) Carrying this analogy one step further, then, the reasonable inquiry standard acts as an encouragement to inspect your minimum daily balance before proceeding. An explicit statement about this obligation was thought

1985); Eavenson, Auchmuty & Greenwald v. Holtzman, 775 F.2d 535, 540 (3d Cir. 1985); Cabell v. Petty, 810 F.2d 463 (4th Cir. 1987); Davis v. Veslan Enterprises, 765 F.2d 494, 497 (5th Cir. 1985); Indianapolis Colts v. Mayor & City Council of Baltimore, 775 F.2d 177, 181 (7th Cir. 1985); Zaldivar v. City of Los Angeles, 780 F.2d 823, 829 (9th Cir. 1985); Donaldson v. Clark, 786 F.2d 1570, 1576 (11th Cir. 1986); Westmoreland v. CBS, Inc., 770 F.2d 1168, 1174 (D.C. Cir. 1985).

This agreement about the objective character of the current Rule 11 standard did not come easily. In two post-1983 decisions, the Seventh Circuit applied the old bad faith standard. Gieringer v. Silverman, 731 F.2d 1272, 1281 (7th Cir. 1984); Badillo v. Central Steel & Wire Co., 717 F.2d 1160, 1166 (7th Cir. 1983). It now has recognized that change, however. See Indianapolis Colts v. Mayor & City Council of Baltimore, 775 F.2d 177 (7th Cir. 1985). It also seems clear that several district judges still are applying subjective bad faith notions and writing opinions denying sanctions because there is no bad faith. E.g., Painter v. Mohawk Rubber Co., 636 F. Supp. 453 (W.D. Va. 1986); Swierkowski v. United States, 620 F. Supp. 149 (E.D. Cal. 1985) (even though a frivolous tax case, no sanctions imposed because case was “fresh”). See also Continental Air Lines, Inc. v. Group Systems Int’l Far East, Ltd., 109 F.R.D. 594 (C.D. Cal. 1986). Nonetheless, the trend to recognize the objective standard is clear and whatever current confusion exists eventually should die out.

57. FErd. R. Civ. P. 26(g).
necessary because too many lawyers were failing to do just that,\textsuperscript{61} and the cost for their neglect was borne unfairly by the opposing party. Indeed, Judge Schwarzer of the Northern District of California has written that the Rule with its expanded standard and mandatory sanctions provides a necessary tool to deter and sanction what has become exceedingly sloppy practice on the part of the bar.\textsuperscript{62}

So, to some, amended Rule 11 is perceived as a gentle nudge to litigators to prepare their cases more carefully, with provision for cost-shifting to compensate opponents for expenses that they should not have to bear. To others, it is more like a call to arms to the judiciary to control and deter poor litigation practices by imposing mandatory sanctions.\textsuperscript{63} Regardless of which view is taken, the conclusion that one must reach when looking at the amended Rule is that there must be some change in the practices of many litigators in order to comply with this newly articulated objective standard.

A review of only the reported opinions dealing with Rule 11 in the first two years of its life reveals some interesting statistics. First, there has been an explosion of cases raising questions regarding whether the Rule's standard has been violated. To put the numbers in perspective, in one study done of the period 1950-1976, when the subjective standard prohibiting frivolous claims and defenses controlled, only nineteen genuinely adversary Rule 11 motions were found.\textsuperscript{64} During the period 1975-1983 only forty cases dealing with Rule 11 (excluding those in which there was a complete failure to sign the pleadings) otherwise appear.\textsuperscript{65} In contrast, however, a Westlaw search from August 1, 1983 to March 1, 1986 reveals over 285 district court opinions and over

\textsuperscript{61} "Litigation, in some quarters, at least, was becoming more like an alley brawl than a search for the truth by respected and respecting professional advocates." Itel Containers Int'l Corp. v. Puerto Rico Marine Management, Inc., 108 F.R.D. 96 (D.N.J. 1985).


fifty appellate court decisions involving Rule 11 sanctions. There were almost as many court of appeals decisions in that two and one-half year period as there were total opinions of district and appellate courts in a thirty-three year period! What is even more striking is the number of those cases in which sanctions were imposed for some violation. In one study that was made of 238 different requests for sanctions, violations were found or warnings were issued in 60.5 percent of the cases, with the most concentrated use being in large urban centers. Sanction requests occurred most often in civil rights cases, securities actions, and in tax litigation involving pro se claimants. Finally, in 38 percent of the cases, the sanction was imposed solely on the attorney, and in 18 percent the court ordered both the client and the attorney to pay.

So what does all this mean for the litigator of the 1980s? Viewed most cynically, it suggests that there is now an entire new area of legal speciality: bringing and defending Rule 11 sanction motions! The sheer number of motions being ruled upon indicates that the addition of this new standard has had the effect (at least initially) of adding yet another preliminary layer of controversy to litigation; each motion and defensive paper filed seems to have attached to it a request that the opponent be sanctioned for violating the Rule. There are even reported cases in which courts are considering whether sanctions should be awarded because of the filing of a Rule 11 sanction motion without making a reasonable inquiry.

But those very statistics, which admittedly look overwhelming in these early stages, do not tell the whole tale. It is not surprising, given the widespread recognition that litigation has gotten out of control, that bench and bar alike have rushed to exploit this new provision or that there are some very important disagreements among the courts on how it is to be applied. It

66. Id. at 1325-29.
69. See supra notes 27-37 and accompanying text.
takes time to absorb shifts in litigation practices, particularly when they are imposed by Rule and all the participants, therefore, must test the parameters of the change.

What is important to keep in mind is that Rule 11 does not really entail any new or alien obligations for the practicing bar;71 dictates of good practice always have commanded that litigators carefully inquire into both the facts and the law underlying their cases. What the Rule does is to seek to ensure that the pressures of business and economics do not result in giving short shrift to this duty. Regrettably, word processing makes wordy obstructionists of us all. The duty to inquire and prepare adequately extends not merely to the client, but also to the court and the judicial system as a whole.72 In effect, then, the approach of the 1980s is to clarify and expand upon the levels of responsibility for attorneys engaged in litigation; the statistics tell us only that the courts are taking this change most seriously and are trying to make certain that change does occur.73

The special responsibilities that the courts now are articulating may be divided into what might be called "The Three Duties." The first duty is to make a reasonable inquiry into the facts and law before filing any paper or making a particular legal argument.74 The second is what has been called the duty of candor, reflecting the obligation to fully apprise the court of all the necessary information that must be considered before it can render a decision.75 The third duty is the obligation to mitigate

71. Rule 11 does not attempt to alter the pleading threshold for initiating litigation. Rather, it opens the possibility of the court scrutinizing the efforts that preceded the filing to ensure that adequate preparation was made. McIntyre's Mini Computer Sales Group, Inc. v. Creative Synergy Corp., 644 F. Supp. 580, 592 (E.D. Mich. 1986); Foster v. Michelin Tire Corp., 108 F.R.D. 412 (C.D. Ill. 1985). By imposing an objective standard, the Rule makes clear that "[t]he day is past when our notice pleading practice - circumscribed only by a requirement of subjective good faith on the pleader's part - plus liberal discovery rules invited the federal practitioner to file suit first and find out later whether he had a case or not." Hale v. Harney, 786 F.2d 688, 692 (5th Cir. 1985). One commentator has suggested that the change conflicts with the legal realist philosophy that inspired the notice pleading system. Note, Pleadings: Developing Standards for Rule 11 Sanctions, 100 HARV. L. REV. 630 (1987).


74. See infra text accompanying notes 77-112.

75. See infra text accompanying notes 113-117.
costs so as to help streamline litigation and achieve judicial economy. A brief look at the courts' treatment of each of these duties as contrasted with past practices best indicates how the lawyer as litigator must change, and already is changing, in this decade.

A. The Duty to Inquire into Facts and Law

The first duty that I have isolated, the duty to make a reasonable inquiry into the facts and law, is reflected in the specific addition to Rule 11 of language stating that the attorney's signature certifies that the pleading or paper is being filed only "after a reasonable inquiry." It has been suggested that that language simply requires each lawyer "to be careful, skeptical, objective, and a judicious professional in all pleading and motion matters." Although these obligations certainly should not be viewed as new, the addition of the language to Rule 11 makes very clear that compliance is to be tested by an objective standard. But is there an agreed-upon test for what constitutes a reasonable inquiry by a "judicious professional" into the facts and law?

An examination of the current case law reveals that there is not yet a consensus as to when the objective standard is violated. Some differences between courts may be explained by the continuing reluctance on the part of some judges to embrace wholeheartedly the ideas underlying Rule 11 of increased judicial control and sanctions for noncompliance, as well as the desire of other courts to "go slowly" in order to give attorneys some time to adjust to these changes. In addition, and perhaps more problematic, the dual nature of Rule 11 sanctions, designed both

76. See infra text accompanying notes 118-125.
78. Kassin, An Empirical Study of Rule 11 Sanctions (Federal Judicial Center 1985). See also cases cited supra note 56, and infra note 79, applying the old standards.
79. E.g., Coast Mfg. v. Keylon, 600 F. Supp. 696, 698 (S.D.N.Y. 1985) (sanction denied against a Delaware corporation that sought to create diversity against a Michigan defendant by suing in its own name on a claim that belonged to its Michigan subsidiary. The court noted: "It is understandable that litigants will do a small amount of artful conniving to gain access to the diversity jurisdiction of the federal courts ... It is our duty to protect the diversity jurisdiction.... In doing so, we need not become punitive."); Baranski v. Serhant, 106 F.R.D. 247, 250 (N.D. Ill. 1985) (mistake is a defense to a motion for sanctions).
to compensate the opponent, as well as to punish and deter violators, may explain some of the apparent confusion. When the object is to punish and deter, it is not surprising that bad faith seems a necessary element. But when the goal is compensation, intent is irrelevant; even the rightdoer should be held accountable. Consequently, the decision as to which one of these goals is paramount has an important impact on the determination by a particular judge as to what constitutes the appropriate standard of conduct, as well as what sanction may be in order for its violation. Regardless of these differences, which should lessen as common standards evolve, some conclusions about the parameters of what constitutes a reasonable inquiry already are apparent.

The simplest principle on which all seem to agree is that there has to be some inquiry into the legal and factual underpinnings of the case. When there blatantly is not, Rule 11 has been violated. It is not appropriate merely to file form pleadings that bear no specific relation to the facts or to pick your defendants from the phone book. Nor should attorneys file complaints not supported by any factual base with the expectation that facts necessary to support a claim will just possibly be found during discovery.

Similarly, some legal basis for the suit must exist. Filing or defending a lawsuit in the face of flatly contrary law cannot be tolerated. Illustratively, courts have dismissed as frivolous suits in which the plaintiff has been suing seriatim, filing the same basic claim over and over again. To the same effect are the taxation cases in which individuals repeatedly challenge the notion that wages are taxable income, claiming immunity from all income taxes, or they challenge the government’s authority to

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83. See, e.g., Brown v. Nationwide Mut. Ins. Co., 805 F.2d 1242 (5th Cir. 1986); Hewitt v. City of Stanton, 789 F.2d 1230, 1233 (9th Cir. 1986); Smith v. United Transportation Union Local No. 81, 594 F. Supp. 96, 100-01 (S.D. Ca. 1984).
85. E.g., Cook v. Peter Kiewit Sons Co., 755 F.2d 1030 (9th Cir. 1985); McKinney v.
impose penalties for filing a frivolous return. On the other hand, if there is a difference of opinion between the trial and appellate courts or there is a dissenting judge in the appellate court who accepts the theory on which a claim or defense is based, then, almost by definition, reasonable underpinnings existed for the losing argument, so that no violation is involved.

More difficult are the cases in which a limited examination has been made and the question becomes whether that inquiry is enough to make plausible the claim that later is filed. The Advisory Committee suggests in its Notes to the amended Rule that judges making the assessment whether a reasonable inquiry has been made should take into account such factors as how much time for investigation was available to the signer; whether he had to rely on a client for information as to the facts underlying the pleading, motion, or other paper; whether the pleading, motion, or other paper was based on a plausible view of the law; or whether he depended on forwarding counsel or another member of the bar.

Necessarily this means a rather careful review, highly dependent on the circumstances of each case. Here also is where the greatest change is being encouraged in litigation practices. A


87. In Indianapolis Colts v. Mayor & City Council of Baltimore, 775 F.2d 177 (7th Cir. 1985), the Colts, in an effort to resolve a dispute over their move from Baltimore to Indianapolis, brought a federal interpleader action seeking to have the court declare the ownership of the franchise. The district court upheld interpleader jurisdiction, but a panel of the Seventh Circuit reversed, with one member dissenting. The Colts petitioned for rehearing, which was denied, but with another Court of Appeals judge voting to allow rehearing en banc. The district court then denied Baltimore's application for fees under Rule 11 and the appellate court affirmed, stating that the fact that the judges who ruled on the merits of the pleading disagreed as to whether the interpleader claim was justiciable was significant evidence that the suit was not frivolous. See also FDIC v. Elefant, 790 F.2d 661, 667 (7th Cir. 1986); Fustok v. Conticommodity Servs., Inc., 618 F. Supp. 1074, 1076 (S.D.N.Y. 1985).


89. One commentator has suggested the following guidelines for the factual inquiry: "Conduct a thorough personal interview with your client and key witnesses; review all pertinent documents; and confirm that the pleading is not designed to harass the adversary. If the facts supporting the pleading are available without discovery, greater factual certainty is required." Shaffer, Rule 11 and the Prefiling Duty, Nat'L L.J., August 18, 1986, at 28, col. 1.
brief description of a few cases best indicates the kinds of problems and questions that now must be confronted by counsel.

(1) Inquiry into the facts—In one case in the District of Colorado, plaintiffs moved to disqualify opposing counsel, alleging that the law firm also represented a bank and had received confidential information regarding plaintiffs from that source. The court ruled that no confidential information had been received and further found plaintiffs in violation of Rule 11 because they had made the disqualification motion without a reasonable inquiry into the facts. The motion had been made on the basis of limited telephone inquiries, without personal interviews of knowledgeable witnesses, and, most importantly, it was filed after plaintiff's attorneys had received some information that contradicted their assertions and should have given them reason to inquire further. The message is clear: it is not sufficient to rely on preliminary information that reveals some serious questions about its reliability, even for purposes of filing that initial pleading; further investigation is required.

More difficult questions are presented for plaintiff's counsel when the facts as revealed indicate a clear defense, but the defense is waivable. Is it consistent with the obligations of Rule 11 to file the pleading knowing it can be destroyed? Some courts have said yes, some no. The problem is an important one. Insofar as courts imposing sanctions in these circumstances do so because the plaintiff's lawyer did not even inquire as to whether the statute of limitations had run or jurisdiction was proper, those rulings are consistent with the purpose of the Rule and serve as a needed reminder to counsel to prepare adequately before filing suit.

But the notion that some matters constitute defenses, easily waived, at least traditionally has meant that the plaintiff has no obligation to raise the matter. Consistent with that view then, Rule 11 requirements would mean only that the plaintiff had an obligation to desist from objecting if the defendant raised the defense because any resistance would be frivolous. Yet some

courts now seem to be suggesting that when the plaintiff files an action knowing there is a defense, that constitutes the filing of an objectively frivolous pleading. Only if plaintiff's lawyer had some reason to believe the defense would not be raised would his conduct be proper. As a practical matter, the only way the attorney could obtain the necessary knowledge would be to contact opposing counsel to see if they would agree. In the case of a personal jurisdiction or venue defense, this approach might be plausible because the defendant might prefer to litigate in plaintiff's chosen forum. However, it is difficult, if not impossible, to imagine such agreement regarding an affirmative defense that will bar liability. Thus, the impact of this interpretation is far-reaching because it effectively transforms a defense into an element of plaintiff's case.

A similar but somewhat different dilemma is presented by a case from the Seventh Circuit: to what degree is the attorney bound when framing the claim or defense by the subjective facts related by the client? The case, Frazier v. Cast, was a civil rights action brought by a widow and children. It arose out of the warrantless entry into their home by the police, resulting in the death of the husband. Defense counsel had argued that exigent circumstances justified the warrantless entry because the police had entered after tear gas had been diffused and for the purpose of saving the life of the decedent. However, depositions of the officers at the scene contained clear statements to the effect that there was no fear of a fire in the home and that their entry was because they had become impatient and thought the decedent was just being recalcitrant. The district court assessed sanctions against defense counsel for his baseless argument, requiring him to reimburse plaintiff's counsel for their work in responding to that argument. The Seventh Circuit affirmed, finding that defense counsel had blatantly misrepresented the defendant officers' motivations.


95. 771 F.2d 259 (7th Cir. 1985).

96. Id. at 265.
The concurring opinion by Judge Flaum is of particular interest. It was not so clear to him that sanctions were warranted. This is because he would distinguish between two cases. The first is one in which an attorney offers an argument refuted by objective facts — that would be clearly frivolous and in violation of the Rule. The second is exemplified by Frazier, in which, as seen by Judge Flaum, the attorney offered a contention not supported by the client's deposition testimony. That situation presented a "close question," which he agreed to affirm only because the standard for review was whether discretion had been abused.97

Although both the majority and the concurrence agreed that a reasonable inquiry must be made, they disagreed as to the latitude given the attorney regarding how to evaluate what is discovered during that inquiry. As seen by the concurrence, the current standard still allows the attorney to disregard some of the evidence revealed in the initial investigation, as long as it is not "objective evidence." The two judge majority would not allow even that much room for maneuvering.

Another question that has emerged under Rule 11 is when the reasonable inquiry standard can be satisfied by relying solely on the client's statements of facts, or on co-counsel? A district court case that is somewhat troubling and that raises this question is Kendrick v. Zanides.99 In Kendrick, Lawyer A agreed to represent Client in a pending criminal case, as well as to investigate whether he might bring a civil rights suit against various prosecuting attorneys and federal government agencies for conspiring to unlawfully seize and withhold some of Client's files and documents. This conspiracy allegedly impeded Client's defense in a prior criminal prosecution.

Lawyer A, after interviewing Client, brought in Co-Counsel, an attorney with considerable civil rights litigation experience. After reviewing the information and documents provided by Client, Co-Counsel concluded that a claim existed and prepared

97. Id. at 266.
98. The Advisory Committee specifically noted that one of the factors that could be considered in determining whether a reasonable inquiry had been made was whether the lawyer had gotten the case on referral or relied on another attorney. Advisory Committee Note to the 1983 Amendment to Rule 11, reprinted in 97 F.R.D. 196, 199.
a complaint, which Lawyer A reviewed and signed, filing suit in state court. Defendants removed to federal court and then moved both for summary judgment and for Rule 11 sanctions.

At that point, Lawyer A went to the attorney who had represented Client during the earlier criminal prosecution — that is, during the time involving the activities that comprised the civil rights action. That attorney reviewed the pleadings for the civil rights claim and stated that he agreed with everything, so Co-Counsel then prepared amended pleadings, which mainly expanded on the original complaint. However, before a hearing on defendants’ motions, Client gave some documents to Lawyer A that for the first time contradicted his earlier allegations. Lawyer A advised the court immediately and asked for a continuance. When contacted and given this additional information, the original defense lawyer continued to maintain he had been denied access to the documents. However, correspondence attached to defendants’ summary judgment motions showed that was not so. Although Lawyer A dismissed the suit with prejudice, the court ordered him to pay the attorney fees for all the defendants.

Judge Schwarzer, who was the sanctioning judge, rejected Lawyer A’s arguments that he had done all that could be expected to have acted in good faith and that his sole failing had been in not supervising his case sufficiently to discover earlier some of its problems. The judge specifically found that at the time the complaint was filed, Lawyer A had no information from a reasonable source to support a belief that the allegations of the complaint were well grounded in fact. The judge noted that Client’s statements were those of a man who was under indictment for mail fraud and who had been convicted previously of the same offense, so that any statement from him should have been viewed with skepticism. The only way for Lawyer A to have made a reasonable inquiry, according to Judge Schwarzer, would have been to have attempted to obtain the controverted documents himself, by making an inquiry of the SEC, the United States Attorneys Office, the storage company, and others. It was not sufficient to rely on the advice of Co-Counsel because the

100. Courts have recognized that what may constitute a reasonable basis for suit may, after discovery, appear clearly frivolous and the attorney’s duty at that point is to dismiss. E.g., Burlington Coat Factory Warehouse v. Belk Bros. Co., 621 F. Supp. 224 (S.D.N.Y. 1985). This is what the lawyer in Kendrick did.
signer had the obligation to make the reasonable inquiry.

Kendrick sets out two precepts about the duty of inquiry imposed on counsel that in themselves should not be too startling. First, litigators have a duty to the court as well as to their clients and that duty requires that they should not rely solely on their client's word if further investigation can reasonably be undertaken to confirm or deny those facts, or if there is some reason to suspect that the client's story is not totally reliable. Second, an attorney cannot avoid the responsibilities of Rule 11 by hiding behind the fact that co-counsel prepared the document at issue; before signing a pleading each lawyer must satisfy himself that it is accurate.

The problem is how to apply these rules in practice. Although the level of investigation suggested by Judge Schwarzer certainly would have revealed the problems that later appeared, the question is whether such an extensive inquiry was clearly necessary when the amended complaint was filed. Remember, the attorney in Kendrick had done more than simply listen to his client's story and review documents he presented; he had enlisted the aid of skilled co-counsel and had consulted with prior counsel, who confirmed the client's allegations. Rule 11 does not state that the attorney must make the best possible inquiry; only a reasonable investigation is mandated. So questions remain about how this standard is to be met, and some of those very questions lie at the heart of how litigation practices may change, or are changing, in this decade.

101. Southern Leasing Partners, Ltd. v. McMullan, 801 F.2d 783, 786 (5th Cir. 1986); Coburn Optical Indus., Inc. v. Cilco, Inc., 610 F. Supp. 656, 659 (M.D.N.C. 1985). See Kamen v. American Tel. & Tel. Co., 791 F.2d 1006, 1012 (2d Cir. 1986) (counsel could rely on client when facts not easily accessible to client and relevant information was within the control of defendant).

102. In Rothschild, Fenton & Swanson, Rule 11: Stop, Think, and Investigate, 11 Litigation 13 (1985), the authors suggest five questions to be considered when deciding whether to rely solely on the client's story before filing. (1) Is the story easily corroborated? (2) Is the cost of corroboration prohibitive? (3) Does the client have actual knowledge or only hearsay? (4) How well do you know your client? (5) Is the story plausible?


(2) Inquiry into law—Similar problems arise when attempting to determine under the newly heightened standard when litigants can, after making a reasonable inquiry into the state of the law surrounding their case, make a good faith argument that the law sustains their claim even though nothing squarely supports it. The problem is especially difficult here, as it is when a factual inquiry is involved, because in tough cases the question involves an exercise of judgment. Since the common law develops by slow changes premised on different facts, the tradition has been to encourage arguments to extend the law. Yet now there appears to be some suggestion that litigators have gone too far, filing clearly frivolous claims or defenses that do not constitute good faith arguments to extend the law.

At present, the courts confronting this problem have not developed a clear or uniform standard. Rather, the decisions in particular cases seem to reflect a basic difference in emphasis about what are the proper concerns under amended Rule 11. Some courts assess whether the Rule 11 standard has been violated against the goal that the standard imposed must not stifle lawyer creativity. These courts, for example, recognize that attorneys appropriately may rely on analogies when making arguments, even if those analogies ultimately prove to be unpersuasive. Other courts appear to feel that lawyers use the argument that they are making an attempt to extend the law simply to avoid the work involved in serious investigation before filing claims or defenses. Indeed, it has even been suggested that Rule 11 includes not only limitations on when to make an argument to extend the law, but notions of how to make the argument as well. Viewed from this latter perspective, major changes in litigation practices will have to be made.

One single example best illustrates the impact these differences in emphasis have. In Zaldivar v. City of Los Angeles, the Ninth

105. The experience of an attorney in the field in which a case is filed may be relevant in assessing whether reasonable judgment was exercised. See, e.g., Huettig & Schromm, Inc. v. Landscape Contractors Council of N. California, 790 F.2d 1421 (9th Cir. 1986).
108. See infra note 115.
109. 780 F.2d 823 (9th Cir. 1986).
Circuit reversed a trial court decision that had found the Rule 11 standard to have been violated. The case arose out of a recall election for a city councilman. Supporters of the councilman filed an action challenging that the recall election was in violation of the Voting Rights Act because the public notice of intention to recall had been printed only in English. The district court dismissed on the ground that the Act required state action and since defendants were private citizens they were not within its purview. The court also noted that a petition to recall was not part of the electoral process covered by the statute. The district judge then ordered attorney fees to be paid to the defendants, finding that even a cursory reading of the Voting Rights Act would have indicated to a reasonable person that there was no basis for the lawsuit. The trial judge commented that a claim does not raise to the level of being novel when it clearly has no legal support. 110

Even though the Ninth Circuit agreed that no federal claim could be established, it reversed the attorney fee award because it found sufficient broad remedial policies underlying the Voting Rights Act to enable a competent attorney to make the plausible good faith argument that it should be extended to the situation involved. Although the conclusion reached by the appellate court seems most compatible with the desire not to stifle creativity in the bar, 111 the very fact that there was heightened scrutiny given to this issue, and a difference between the district and appellate courts, suggests that lawyers must raise their own standards of what constitutes a "viable novel argument" as contrasted to a "shot in the dark." As noted the Seventh Circuit, "Rule 11 requires counsel to study the law before representing its contents to a federal court. An empty head but a pure heart is no defense." 112 There must be some basis for the court to find it objectively reasonable that the law could be changed in the direction being argued, even if the court is not ready to make that move at that time. To the extent that prior practice seemed

111. "The rule is not intended to chill an attorney's enthusiasm or creativity in pursuing factual or legal theories. The court is expected to avoid using the wisdom of hindsight and should test the signer's conduct by inquiring what was reasonable to believe at the time the pleading, motion, or other paper was submitted." Advisory Committee Note to the 1983 Amendment of Rule 11, reprinted in 97 F.R.D. 195, 199.
112. Thornton v. Wahl, 787 F.2d 1151, 1154 (7th Cir. 1986).
to encourage throwing in every conceivable argument in the hope
that one of them would convince, a more careful judgment on
the part of counsel now is required.

B. The Duty of Candor

In addition to the duty of reasonable inquiry, some courts have
suggested that the decision of counsel making a novel argument
or one that is designed to extend the law now also may be
evaluated against what is being termed the Duty of Candor. This
second duty involves some consideration of how to make an
argument, not just whether to make it. In fact, the Duty of
Candor, like the Duty of Inquiry, is not a new concept. Under
the various canons and codes of ethics that govern the legal
profession, the obligation of counsel to reveal adverse precedent
to the court always has been recognized. Indeed, even in the
absence of mandatory rules, prudence and effective advocacy
often will dictate disclosure. What is new is that the obligation
to make disclosure now is appearing blatantly in judicial deci-
sions, and there is a serious suggestion that it may be enforced
as part of the courts' Rule 11 supervisory responsibilities.

To the extent that Rule 11 is viewed as an important weapon
with which courts can restrain overzealous advocacy, the notion
that sanctions may be imposed upon an attorney who makes an
argument without citing contrary precedent or in some other
improper way so as to mask the absence of authority seems
clearly within the scope of the provision. A review of that conduct
essentially falls within the court's power under the Rule to ensure
that the attorney has made "a good faith argument for the
extension, modification, or reversal of existing law." However, it
cannot be ignored that the courts' enforcement of a duty of
candor under their Rule 11 authority represents a marked en-
largement of the scope of judicial scrutiny and supervision of
lawyer conduct. Just as the professional responsibility codes
always have contained some provisions regarding lawyers' obli-

113. See A.B.A. Model Rules of Professional Conduct, Rule 3.3(a)(3) (1983); A.B.A. Model
115. Jorgenson v. County of Volusia, 625 F. Supp. 1543 (M.D.Fla.1986); Itel Containers
gations on these matters, so too traditionally the courts have left enforcement largely to the organized bar.

Thus, perhaps not surprisingly, one court of appeals that has confronted this question, the Ninth Circuit, has rejected the notion that Rule 11 embraces the authority to police the Duty of Candor. The court specifically declared that a duty of candor does exist, but felt that to bring it within the scope of Rule 11 was unnecessary because other enforcement mechanisms can be used, and that any other conclusion would impose too great an obligation on the courts to investigate and police, with the potential of chilling appropriately creative advocacy. On the other hand, the Eleventh Circuit has upheld the imposition of Rule 11 sanctions against an attorney in a civil rights action who was found to have violated the duty of factual candor. The lawyer had sought attorney fees without revealing that there was a settlement agreement that foreclosed claims for fees and that he nevertheless felt he could claim them under Section 1988.

Thus, the Ninth Circuit’s decision to adopt a narrow reading of Rule 11 does not undercut the notion that the litigator of the 1980s had best pay careful attention not only to what arguments are advanced, but also to making certain that all that are advanced can be made consistently with counsel’s Duty of Candor. The very fact that the courts are now openly discussing this obligation and grappling with the best means to enforce it signifies that the time has come for increased awareness and some improved practices on the part of the bar. Consequently, insofar as litigators have become lax, or worse, in honoring their obligations to present their arguments with candor and forthrightness, their tactics must change.

Indeed, perhaps the time has come for attorneys to approach the bench more forthrightly. Instead of overwhelming the court with pages of string citations, many of which are tangential at best, in order to prove the strength of their position, an acknowledgment that a particular argument has no clear authority, other

116. Golden Eagle Distributing Corp. v. Burroughs Corp., 801 F.2d 1531 (9th Cir. 1986). A petition for rehearing en banc was denied, but a dissenting opinion by Judge Noonan for five members of the court elaborates some of the limits and failings of the panel’s opinion. 809 F.2d 584 (9th Cir. 1987). See also Continental Airlines, Inc. v. Group Systems Int’l Far East, Ltd., 109 F.R.D. 594 (C.D. Cal. 1986).

than strong policy and common sense, may be much more powerful in this era in which judges are complaining in increasing numbers about the tendency of litigators to exaggerate and overwhelm. To some extent, the ease of computerized legal research systems and word processors have aided in producing the problem. And lawyers trained to do combat in the adversary system may shudder at this type of acknowledgment. However, such an approach should be much more persuasive than a sham reliance on authorities that the judge readily can see through. It represents just one more way in which the modern litigator should consider some change in the way he prepares his case.

C. The Duty to Mitigate Costs

The third and last duty that recently has appeared actually represents a new obligation that is part of the trend of the 1980s: the duty to mitigate costs. The notion that the judicial system, as well as the litigants themselves, no longer can afford endless motion practice and delays flavored much of the literature of the late 1970s. What we are seeing now is the courts' attempts to address the issue. The Supreme Court confronted the cost problem in the discovery area by promulgating amendments to the discovery rules that allow, indeed urge, the district judges to restrict discovery or order sanctions if they find that it is not being accomplished in an economical manner. There is so little case law yet applying this criteria that it is difficult to assess how effective it is or will be. Nonetheless, the important thing to note is that the principle of going forward in litigation in the


119. Specifically, the amended Rule now provides that discovery "shall be limited by the court if it determines that: (i) the discovery sought is unreasonably cumulative or duplicative, or is obtainable from some other source that is more convenient, less burdensome, or less expensive; (ii) the party seeking discovery has had ample opportunity by discovery in the action to obtain the information sought; or (iii) the discovery is unduly burdensome or expensive, taking into account the needs of the case, the amount in controversy, limitations on the parties' resources, and the importance of the issues at stake in the litigation. The court may act upon its own initiative after reasonable notice or pursuant to a motion under subdivision (e)." FED. R. CIV. P. 26(b)(1).
The most economical manner today clearly is articulated in the Federal Civil Rules themselves.

The duty to minimize costs is a theme that also appears outside the discovery arena. For example, now that attorney fee awards rapidly are becoming almost commonplace in federal litigation, it is worth noting that the Supreme Court has specifically limited statutory fees to only those amounts that compensate for time reasonably expended. This sensible constraint has spilled over into other areas. In particular, what seems to be emerging is a sense that a lawyer faced with a violation of Rule 11 by his opponent should pursue the least expensive means of bringing the matter to the opposing counsel's and the court's attention. A failure to do this may result in an award of fees less than the amount expended. For example, in one case in which the defendants succeeded in obtaining a summary judgment and then sought $22,000 in fees and costs expended in defense, the court ordered plaintiff to pay only $7,500, noting that when the suit was so patently frivolous, defendants should have raised that point in a telephone status conference with the judge rather than proceeding through the expensive formality of summary judgment.

The converse proposition also appears to be true. That is, if counsel's attempts to bring to the opponent's attention the defect in the pleadings or motion have been ignored, fees may be awarded most readily, even though the position taken originally would not have been deemed to violate Rule 11. Illustratively, fees were awarded against plaintiff's lawyer in one Title VII case.

123. Counsel need not be bound by the conclusory assertions of his opponent, however. Only when the opposing counsel has presented the facts or the legal authority to support the contention that there is no basis for the claim does Rule 11 come into play. See Kamen v. American Tel. & Tel. Co., 791 F.2d 1006, 1010 (2d Cir. 1986). Compare Friedgood v. Axelrod, 593 F. Supp. 395, 398 (S.D.N.Y. 1984) (plaintiff's attorney not bound to rely on representations of opposing counsel, even if presented with convincing and objective data when he had not been given sufficient opportunity to familiarize himself with the case).
when defense counsel advised plaintiff, by letter, of cases clearly ruling that plaintiff's claim had no legal basis because he failed to file first with the EEOC. The court stated that it would have excused the failure to find that authority at the time suit was filed, but after plaintiff was put on notice of the law and still continued to assert its baseless legal position, Rule 11 was violated.

Taken together, the notion that litigators should try to bring problems to the attention of their opponents and the court in the least expensive manner, and that the failure to do so will result in sanctions that otherwise might not be applied, represents a healthy attempt to encourage the bar to resolve some of their problems by telephone and by letter, rather than by formal motions in court. In this way, litigators, with a bit of judicial prodding, may raise their own standards and Rule 11 will become self-enforcing. Necessarily, changes of this order are slow to come about and sometimes difficult to identify. However, it is clear that this is the trail on which the courts are embarked.

V. Conclusion

In the decade of the 1970s the courts further opened the doors to complex litigation and tried to allow discovery to be self-operative. In the 1980s it appears acknowledged that such freedom has gotten out of control with the result that the entire civil litigation system has suffered. Consequently, procedural changes in this decade represent an attempt to retrench somewhat and to remind the bar of some basic precepts that should underlie all civil litigation. In the early years of this movement, the courts necessarily must keep tight rein in order to force some reevaluation. Although it always is questionable whether the increased use of sanctions is the best method to effectuate change in underlying conduct, there is no doubt that it has


125. This approach may be applied to the problem of the plaintiff who files a claim knowing a waivable defense exists. See supra text accompanying notes 91-93.

made the litigating bar more aware of the problems presented and also has created some powerful (albeit negative) incentives for more careful preparation. But there is a sunny side to this. There are clear signs that the ultimate goal is to encourage litigators, through judicious use of both the carrot and the stick, to become their own judges. Indeed, the truly successful operation of Rule 11 will see that it works itself into extinction. To the extent some of the increased attention to the need to control lawyers reflects a decline in the belief that the members of the legal profession are part of the leaders of society, it is time to bring about a renaissance of faith. The objective is to increase the quality of lawyering so that the “Litigator of the 1980s” can become extolled for careful preparation, for candor in making legal arguments, and for sensitivity and care in keeping the costs of litigation manageable.
DAMAGES AWARDED TO A DEFRAUDED TAX SHELTER INVESTOR CANNOT BE REDUCED BY THE VALUE OF TAX BENEFITS RECEIVED:
RANDALL v. LOFTSGAARDEN

Steve Trumbo*

"Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."

J. Learned Hand¹

The Eighth Circuit Court of Appeals ruled in the action of Austin v. Loftsgaarden (Austin I) that it will reduce a rescissory damage award granted to a defrauded securities purchaser who participated in a tax shelter investment scheme by the value of the federal income tax benefits derived from the investment.² On appeal following remand, the Eighth Circuit Court of Appeals, sitting en banc, reaffirmed this decision in a second hearing of Austin v. Loftsgaarden (Austin II).³ The Ninth Circuit ruled contrary to the Austin courts on this particular issue,⁴ while the Second Circuit followed the lead of the Eighth Circuit.⁵ The United States Supreme Court granted certiorari to review the Eighth Circuit's Austin II decision in the appeal of Randall v. Loftsgaarden⁶ in order to resolve the conflict between the federal circuits on this issue. Justice O'Connor authored the Court's opinion, which reversed the Eighth Circuit on the grounds that

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* J. D. Chase Law School, 1987.
the federal securities laws do not recognize tax deductions as income received for the purpose of calculating an award of damages.\(^7\)

Before considering the Supreme Court's decision, this article will examine the decisions of the Eighth Circuit in *Austin I* and *Austin II* and other relevant decisions. The discussion of the Supreme Court's decision will present the ruling and rationale of the Court's majority, as well as the concurring opinion of Justice Blackmun\(^8\) and the dissent of Justice Brennan.\(^9\) Each opinion resolves the issue of whether an award of money damages granted to a tax shelter investor who brought suit pursuant to the federal securities laws should be reduced by the value of tax benefits generated by the investment differently, depending upon the writing Justice's perception of the economic reality of such an investment. First, however, it is important to have a basic understanding of tax shelters and how they produce an economic benefit to the investor.

**TAX SHELTER DEFINED\(^{10}\)**

American citizens, rich and poor alike, mount a constant struggle to preserve taxable dollars from the clutches of Uncle Sam in pursuit of the economic reality aptly expressed by Judge Learned Hand in the introductory quote.\(^{11}\) One popular means of reducing the amount of taxes one must pay is to invest in so-called "tax shelters." These investments come in a multitude of forms and sizes, ranging from small retirement accounts - e.g., Individual Retirement Accounts (IRA) and Keogh Accounts - to large real estate ventures, oil and gas exploration, equipment leasing, farming, and research and development projects.\(^{12}\) The retirement accounts serve as tax shelters because the Internal Revenue Code (IRC) permits the deferral of taxation by allowing the depositor to deduct the amount contributed to a qualified

\(^8\) Id. at 3143, 3155.
\(^9\) Id. at 3157.
\(^10\) The following text will, in the most cursory manner, introduce the topic of tax shelters in order to better frame the issues presented herein. A more comprehensive treatment of the topic of tax shelters is beyond the scope of this article.
\(^11\) 69 F.2d at 810.
\(^12\) *Arthur Anderson & Co., Tax Shelters - The Basics* (1983).
account each year from gross income. The funds in the account are not included in gross income until they are recovered at a subsequent time. Moreover, the depositor may find himself in a lower tax bracket at the time of withdrawal than he was in at the date of deposit, thereby realizing a tax savings. However, the heart of the tax shelter industry, and those tax shelters affected by the Supreme Court’s decision, lies in real estate, oil and gas exploration, equipment leasing and other sizable investments.

Commentators have developed numerous definitions of the term “tax shelter,” ranging, like the creature itself, from the simple to the complex. The important difference between the various definitions, aside from the types of investments included or excluded, relates to which aspect of the investment is emphasized. As evinced by Justice Brennan’s dissent in Randall v. Loftsgaarden, tax shelters are often described in terms which stress the investment’s ability to produce sizable tax advantages for the investor. Others argue that the potential held by the underlying investment to produce a profitable return secures the viability of the scheme and stands as a “copartner” to the promise of tax benefits. This latter position recognizes that if a tax shelter investment only promises to create favorable tax consequences, and does not aim to produce future profits, it will likely fail. The proponents of the latter position also view the provisions of the tax code which are relied upon in creating tax shelters as spurs to risky investment; those who adhere to the former position consider these provisions as glaring examples of the tax code’s inequity.

13. I.R.C., § 219 (West Supp. 1987). The tax code allows for a deduction from gross income amounts up to $2,000.00, or $2,250.00 for certain married individuals, contributed to a qualified employee or employer retirement plan or individual retirement account (IRA). Amounts deducted in this way are includable in gross income when received pursuant to I.R.C., § 72 (West Supp. 1987). Contributions made to self-employment retirement plans or Keogh Accounts, pursuant to I.R.C. § 404 (West Supp. 1987) receive tax treatment similar to the IRA plans.
The IRC provisions permitting, and encouraging, tax shelter investments are not the product of congressional caprice or misadventure. Rather, in many instances, Congress carefully drafted these provisions in order to encourage investment in certain high-risk business ventures or enterprises that it perceived as necessary for economic and social stability. Congress clearly adopted this position by drafting IRC provisions which permit the IRS to disallow deductions created by investments which hold no greater business purpose than to create tax benefits. Congress and the IRS have, in recent years, expressed concern over the proliferation of tax shelter schemes less concerned with profit than with tax savings, and have taken measures to restrict their use. In addition to imposing substantial penalties for the "understatement" of tax, the regulatory scheme developed by Congress and the IRS applies a negative definition to the term "tax shelter" by associating the term with tax avoidance and, connoting culpability, tax evasion.

The IRS defines a tax shelter as a partnership, entity, or any arrangement in which the principal purpose "is the avoidance or evasion of Federal income tax." Generally, commentators define the term as an investment which reduces taxable income by creating deductions from gross income in amounts greater than the additional income produced through the investment. By this method, the investment "shelters" other income from taxation.

The American Bar Association's Committee on Ethics and Professional Responsibility developed a commonly used definition.
that, like the immediately preceding definition, focuses on the
tax-saving aspects of a tax shelter investment. The American
Bar Association’s definition states in part that:

A “tax shelter” ... is an investment which has as a significant
feature for federal income or excise tax purposes either or both
of the following attributes: (1) deductions in excess of income from
the investment being available in any year to reduce income from
other sources in that year, and (2) credits in excess of the tax
attributable to the income from the investment being available in
any year to offset taxes on income from other sources in that
year.\footnote{28}

The American Bar Association excludes investments such as
municipal bonds, annuities, qualified retirement plans, individual
retirement accounts, mineral development ventures (if the only
tax benefit would be percentage depletion), and real estate from
this definition where it is anticipated that deductions and credits
will not meet the definitional criteria.\footnote{29}

The previous definitions are representative of those offered by
the “tax motive” commentators who concentrate on a tax shelter’s
ability to produce significant economic advantage through reliance
upon the federal tax code. However, a broader definition,
one including notions of profitability, provides a more realistic
description of tax shelters. A preferred definition would combine
concern with an investment’s profit motive and the idea of
beneficial tax consequences. A good definition states:

A tax shelter investment is an outlay of funds at risk to acquire
something of value, with the expectation that its holding will
produce income and reduce or defer taxes and its ultimate dispo-
sition will result in the realization of gain.\footnote{30}

Furthermore, this definition comports with the IRC provisions
and treasury regulations which limit and define the acceptable
uses of tax benefits.\footnote{31}

The magic and purpose of a tax shelter is its ability to reduce
tax burdens by creating artificial losses in a current tax year
and deferring tax assessment into a future year when a taxpayer
may be subject to a lower rate or ordinary income can be re-

\footnote{28. Id.}
\footnote{29. See id. at notes 17, 18, 19 and accompanying text.}
\footnote{30. Arthur Andersen & Co., supra note 12, at 15.}
\footnote{31. See infra notes 20 through 25 and accompanying text.}
characterized as capital gain taxed at a lower marginal rate.\textsuperscript{32}

Artificial losses are those created by the IRC through depreciation,\textsuperscript{33} mineral depletion allowances,\textsuperscript{34} and deductions permitted for interest paid for amortization of a mortgage and other expenses.\textsuperscript{35}

The use of leveraged financing through mortgage loans, usually important to a tax shelter investment scheme, also gives an investor the ability to await increased property value with the use of a lender's dollars while the lender will receive only the rate of return for which he contracted.\textsuperscript{36} If the investment assets are liquidated in the sufficiently distant future, profit realized by the investor from the increased value of the property may receive preferred treatment as a long-term capital gain taxed at a lower marginal rate.\textsuperscript{37} The use of tax credits may also provide tax sheltering opportunities.\textsuperscript{38}

The Tax Reform Act of 1986 restricted the use of tax shelters by limiting the amount an individual may deduct from gross income to those amounts for which he is "at risk."\textsuperscript{39} Generally, a person is considered at risk up to the amount of cash and adjusted basis of other property contributed to the investment which he stands to lose.\textsuperscript{40} Also, a taxpayer is considered at risk, and may


\textsuperscript{33} See generally, I.R.C., § 167 (West Supp. 1986) (Depreciation by the straight line method, declining balance method, and the sum of the years method); I.R.C., § 168 (West Supp. 1986) (Depreciation by Accelerated Cost Recovery System). This section has been modified by the Tax Reform Act of 1986; see also, Prentice Hall, supra note 32 at para. 1.3, at 9-11.

\textsuperscript{34} See generally, I.R.C., § 611 (West 1986); see also, Arthur Anderson & Co., supra note 12, at 56.

\textsuperscript{35} Haft & Fass, supra note 32, § 2.06, at 2-58.

\textsuperscript{36} Arthur Anderson & Co., supra note 12, at 35.


\textsuperscript{38} See generally, I.R.C., §§ 38, 49 (West Supp. 1987). I.R.C., § 38 provides a tax credit for investments in certain depreciable property.I.R.C., § 48 provides a tax credit for rehabilitating qualified buildings. I.R.C., § 48(1) provides a tax credit for investment in certain energy properties.

\textsuperscript{39} I.R.C., § 465 (West Supp. 1987); see also, Fierro, supra note 18, at 44, 45.

\textsuperscript{40} I.R.C., § 465; see also, Prentice Hall, supra note 32, at para. 1.5, pp. 11, 12.
claim deductions, up to the amount of borrowed funds contributed to the investment for which the creditor has a right of recourse against the investor or which the investor collateralized with other property.\textsuperscript{41} However, the Act did not extend the "at risk" requirement to investments in real property (other than mineral property); therefore, money contributed from a non-recourse loan will qualify the investor for allowable deductions.\textsuperscript{42} This simple provision of the IRC has significantly enhanced the desirability of real estate tax shelters.\textsuperscript{43}

**THE LIMITED PARTNERSHIP AS A FORM OF TAX SHELTER INVESTMENT**

The most common form of business association utilized in tax shelter investments is the limited partnership.\textsuperscript{44} The Subchapter S Corporation also offers a suitable and popular vehicle to participate in a tax shelter because it shares many taxation characteristics with the partnership form.\textsuperscript{45} Investors prefer the limited partnership form because it allows tax advantages and other economic benefits to pass through the organization directly to the individual partners.\textsuperscript{46} Equally important to the investor, a limited partnership partially shields the investor from exposure to the partnership's liabilities and risk of loss.\textsuperscript{47} Generally, a limited partner is exposed to partnership liability only to the extent of his investment.\textsuperscript{48} Another advantage is that the limited partnership form uses a general partner to oversee the daily activities of the partnership and to manage its assets, thereby removing the limited partner from the necessity of making day-to-day decisions.\textsuperscript{49}

The characteristics of the limited partnership which make it an attractive form of tax shelter investment derive from the law of partnership\textsuperscript{50} and the provisions of the IRC.\textsuperscript{51} Pursuant to

\textsuperscript{41} I.R.C. § 465.
\textsuperscript{42} I.R.C. § 465(c)(3)(D); Haft & Fass, supra note 32, § 2.08, at 2-102, 2-103.
\textsuperscript{43} Fierro, supra note 18, at 92.
\textsuperscript{44} Haft & Fass, supra note 32, § 2.02, at 24.
\textsuperscript{45} Arthur Anderson & Co., supra note 12, at 16, 17.
\textsuperscript{46} Haft & Fass, supra note 32, § 2.02, at 24.
\textsuperscript{47} Arthur Anderson & Co., supra note 12, at 15.
\textsuperscript{48} Id.
\textsuperscript{49} Id. at 5.
\textsuperscript{51} I.R.C. §§ 701-61 (West 1982).
Article 3 of the Uniform Limited Partnership Act (ULPA), a limited partner does not ordinarily incur liabilities of the organization to third parties, unless he participates in the control of the business. Absent a limited partner's activity in control or management of the organization, he is liable to the partnership only to the extent he has promised to contribute. A general partner in a limited partnership assumes the liability of the limited partnership to third parties, and has the responsibility to control and manage the affairs of the partnership as if he were a partner in a general partnership. While the limited partner enjoys both protection from unexpected liability and freedom from the concerns of management, he shares in the profits and losses of the partnership and has a right to share in distributions of cash and other assets.

Limited partnerships receive tax treatment identical to that of general partnerships under the IRC; the partners are taxed for the partnership in their separate and individual capacities. This same rule permits partners to claim items allowable as deductions to the partnership as deductions from their personal gross income. They may also claim the partnership's tax credits. A partner computes his "distributive share" (income, deductions and credits earned through the partnership) proportionately with his level of participation in the partnership.

While the limited partnership form ordinarily funnels all tax consequences of the venture to its members, one critical caveat exists. The IRS may determine that the limited partnership should be taxed under the rules for corporate taxation if it decides that the limited partnership actually functions as a corporation. The United States Supreme Court has recognized the IRS’s right to classify business organizations solely for tax purposes even though the classification does not conform to common

52. U.L.P.A. §§ 303(a) and (b). Subsection (b) sets out criteria to determine if a limited partner participates in the control of the business.
57. U.L.P.A. § 504.
59. I.R.C. § 702; see also Treas. Reg. § 1.702-1.
61. See HAFT & FASS, supra note 32, §§ 2.02, at 2-4, 2-5.
law or state law definitions. The IRS specifically retains the right to classify a limited partnership as an ordinary partnership or as an association. The service lists six characteristics of a business association that it will consider in determining whether to tax a limited partnership as a partnership or as a corporation. The courts place great emphasis upon the facts of a particular case and the expressed intent of the parties when classifying business organizations for tax purposes.

A CONTRACT TO PURCHASE AN INTEREST IN A LIMITED PARTNERSHIP IS A SECURITY UNDER THE FEDERAL SECURITIES LAW

The case of Randall v. Loftsgaarden arose upon the complaint of tax shelter investors that the promoter of the investment, Loftsgaarden, violated federal and state securities law by making fraudulent misrepresentations in an investment scheme he marketed through a limited partnership. Though neither the Supreme Court nor the Eighth Circuit Court of Appeals in Austin I or Austin II discussed whether a contract to purchase an interest in a limited partnership is a security, federal courts generally accept the proposition that such a contract is a security. Courts that have addressed the issue point out that both Acts include investment contracts within the definition of the term "security." The well-established test to determine if an investment contract is, in fact, a security under the securities Acts was set out by the United States Supreme Court in its 1946

64. Treas. Reg. § 301.7701-2; see also Morrissey, 296 U.S. at 359.
65. See Grant Auto Parts, Ltd. v. Commissioner, 13 T.C. 307 (1944) (The Tax Court looked to the intention of the parties in determining that a partnership should be taxed as a corporation); Glendser Textile Co. v. Commissioner, 46 B.T.A. 176 (1942) (The Board of Tax Appeals ruled that a limited partnership formed pursuant to New York's version of the U.L.P.A. should be taxed as a partnership and not as a corporation); Priv. Litr. Rul. 8,046,064 (1980).
decision *Securities and Exchange Commission v. W.J. Howey, Co.*

[A]n investment contract for purposes of the Securities Act means a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.

The *Howey* Court found that the combination of a land sale contract and a service contract for a small portion of a Florida citrus grove qualified as a security under the Securities Act. Courts have extended the *Howey* test to apply to determinations under the Exchange Act as well.

Federal courts dealing with limited partnership interests routinely apply the *Howey* test to support the position that the partnership contract is an investment contract under the Acts. However, courts will not do this where the limited partners have involved themselves in the management of the investment. The Second Circuit Court of Appeals has summed up the rule. "[A] limited partnership interest ... involves investment 'in a common enterprise with profits to come solely from the efforts of others.'"

Since a limited partnership contract is a security, the tax shelter investor in a limited partnership gains the benefit of the protections provided by the federal securities Acts. The Eighth and Second Circuits have ruled, in essence, that tax shelter investors deserve less protection because they gain an economic return from a source foreign to the investment property - i.e., the IRC. The Supreme Court has disagreed, ruling that Congress did not intend to extinguish the purpose of the Acts merely

70. Id. at 298-299.
71. Id. at 299.
72. See e.g., Mayer v. Oil Field System Corp., 721 F.2d 59, 65 (2d Cir. 1983).
73. See cases cited supra note 67.
74. Frazier v. Manson, 651 F.2d 1078 (5th Cir. 1981).
75. Mayer, 721 F.2d at 65.


\footnote{Coopers, 34 F.R.D. at 485-86.

\footnote{Wiesenberger, 35 F.R.D. at 558.}}}}

**RELEVANT PRIOR DECISIONS**

The Eighth Circuit's decision in *Austin I* was the first federal appellate decision to directly address the effect of tax consequences on a damages award in a securities civil liability or fraud action arising from a tax shelter investment scheme.\footnote{Comment, Austin v. Loftsgaarden: Securities Fraud in Real Estate Limited Partnership Investments - Offsetting Plaintiffs' Relief to the Extent of Tax Benefits Received, 16 Creighton L. Rev. 1140 (1983); Comment, Securities: Tax Shelter Investment Fraud - Should Tax Savings be Considered in Determining Amount of Recovery? 38 Okla. L. Rev. 334 (1985).} However, the Eighth Circuit did not write upon a wholly clean slate. A number of published opinions dealing with the issue existed at the time of the Eighth Circuit's decision. However, these decisions had not produced a clear rule on the issue.

The two earliest opinions addressing the problem arose out of discovery disputes.\footnote{Coopers v. Hallagarten & Co., 34 F.R.D. 482 (S.D.N.Y. 1964); Wiesenberger v. W.E. Hutton & Co., 35 F.R.D. 556 (S.D.N.Y. 1964).} In both cases the defendants attempted to subpoena the plaintiffs' tax records to a deposition in order to produce evidence that the plaintiffs had received substantial tax advantages from participation in the tax shelter investments which were the subjects of the litigation. The defendants argued that evidence produced through these depositions would be relevant to the issue of damages. In *Coopers v. Hallagarten & Co.*, the Court made three responses: (1) IRS allowed deductions have no bearing on the issue of a plaintiff's recovery; (2) should the plaintiff prevail, the IRS will subject the award to appropriate tax treatments; and (3) the requested damages reduction would work an unequal treatment to other investors of varying tax brackets otherwise similarly situated.\footnote{Coopers, 34 F.R.D. at 485-86.}

The defendants, in *Wiesenberger v. W.E. Hutton & Co.*, advanced the argument that a refusal to reduce a damage award by the amount of tax benefits derived by the plaintiff would work an "injustice" upon them.\footnote{Wiesenberger, 35 F.R.D. at 558.} The court curtly countered:
The claim is for damages caused to plaintiff by defendants. These are capable of ascertainment if the claim is sustained on the merits. Having been ascertained, it would be a great "injustice" to plaintiff to reduce such damages for extraneous reasons wholly unconnected with the acts of defendants.\textsuperscript{82}

In the case of \textit{Dupuy v. Dupuy} the Fifth Circuit discussed the issue of whether tax benefits should be considered when determining damages for tax shelter securities fraud.\textsuperscript{83} Without directly deciding the issue, the court suggested that tax benefits might be a legitimate consideration in ascertaining whether an award of damages in a tax shelter securities fraud case is excessive.\textsuperscript{84}

The decisions in \textit{Bayoud v. Ballard}\textsuperscript{85} and \textit{Bridgen v. Scott}\textsuperscript{86} each partially deal with the issue of whether the value of the tax benefits that flowed to a defrauded tax sheltering investor should offset award damages. This issue was left undecided because both courts found that the defendant had not misrepresented the deal.\textsuperscript{87} The courts reasoned that the individual investors were sufficiently sophisticated to permit them to have understood the nature of the investments and the risks involved.\textsuperscript{88} However, the

\textsuperscript{82}. Id.
\textsuperscript{84}. Id.
\textsuperscript{85}. 404 F. Supp. 417 (N.D. Tex. 1975). The Bayouds, investors/plaintiffs, were brothers seeking a tax shelter from defendant Ballard in which to invest profits from the sale of their medical clinic. The Bayouds invested $700,000.00 in a private offering that involved oil and gas exploration. They subsequently sued Ballard under various provisions of the Federal Securities Acts, including Securities and Exchange Commission reporting requirements and civil liability and fraud provisions. The court found no violation of the reporting requirements. The court also held that the defendants had not misrepresented their exploration program. Instead, the court found that the defendants had managed, or mismanaged, the exploration programs in such a manner as to achieve the desired tax results.
\textsuperscript{86}. 456 F. Supp. 1048 (S.D. Tex. 1978). The defendant, Scott, took an option to purchase a certain strategically located tract of land containing 45.53 acres for $4,000,000.00 with the intent of quickly selling it for speculative profit. When an attempted initial public offering to finance the purchase failed, Scott devised a limited partnership scheme which offered sizable tax benefits to investors. The scheme relied upon a non-recourse loan that exceeded the value of the property. Scott's efforts to sell the property at a profit proved unsuccessful after an economic slow down in late 1974. The investors sued for rescission, attorney's fees and exemplary damages. The court ultimately ruled that the plaintiffs could not recover under the Securities Acts because they had knowledge of all relevant facts.
\textsuperscript{88}. \textit{Bayoud}, 404 F. Supp. at 426; \textit{Bridgen}, 456 F. Supp. at 1051.
*Bridgen v. Scott* court opined that, under different facts, the tax benefits would be a proper topic for jury consideration.\(^8\)

The 1981 decision of *Sharp v. Coopers & Lybrand* discussed the issue of the value of the tax benefits offered by a tax shelter from a slightly different angle.\(^9\) In *Sharp*, investors, including Muhammed Ali, sued the defendant accounting firm for perpetuating the misrepresentations of the promoter of an oil and gas drilling venture in an opinion letter detailing the tax value of the venture.\(^1\) The trial court determined that the accounting firm was liable under section 20(a) of the Exchange Act\(^2\) for misrepresentations associated with the sale of a security.\(^3\)

The opinion, in essence, concluded that the tax benefits were a factor of importance to investors. This was demonstrated by the fact that they had relied upon the tax advice of the defendant in determining whether or not to invest. However, the Court further ruled that the measure of damages should be the “amount of money invested minus the value of the speculative investment at the time of purchase.”\(^4\) The damage award, said the Court, should not be based on predicted tax benefits. While the Court was not explicit in its language, the “speculative value” it referred to would be the amount investors placed “at risk,” and the amount to which the IRC would restrict deductions.\(^5\) The Court determined that the amount lost for tax purposes might not equal the speculative value and ruled, therefore, that the damage award should not be based on the value of tax consequences.\(^6\)

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\(^8\) *Bridgen*, 456 F. Supp. at 1058-59, 1061. In this regard, the court stated: “In retrospect, it is now apparent that this case was really decided when the court ruled on the plaintiffs’ motion in limine. The plaintiffs, prior to the introduction of evidence, attempted to persuade the court that no evidence should be introduced relating to the tax aspects of this transaction. The court, at that time, overruled the motion in limine because it was apparent to this court that in any investment of this nature, tax considerations were crucial . . . . Requiring the jury or this court to try this case without reference to the tax consequences of the transaction would be requiring the jury and the court to live in an artificial ‘never-never land.’”


\(^1\) *Id.* at 178.


\(^3\) *Id.* at 185 (3d Cir. 1981).

\(^4\) *Id.* at 180.

\(^5\) I.R.C., § 465.

\(^6\) *Sharp*, 649 F.2d at 191 n.22.
AUSTIN v. LOFTSGAARDEN

Not unlike the cases discussed above, the litigation giving rise to the decision in Randall v. Loftsgaarden originated when disgruntled tax sheltering investors became concerned that the promoter had misrepresented the feasibility and profitability of their underlying investment. The facts presented by the Eighth Circuit in Austin I reveal that Loftsgaarden, an attorney, had prepared an offering memorandum for participation in Alotel Associates, a limited partnership formed to build a Ramada Inn.97

The offering memorandum described the venture as a tax shelter designed to provide pass-through tax deductions to high bracket investors.98 Despite attractive tax sheltering features and the advantage of achieving an increased basis through the use of non-recourse loans, the initial offering attracted only one investor.99

As a result, Loftsgaarden terminated the first offering and reworked the scheme to provide greater tax incentives at less initial cost to the investors. The revised project reduced the required capital and increased tax deductions by substituting a purchase of the land for a sale leaseback, a change which ultimately positioned Alotel Associates as a sublessee of one of Loftsgaarden's closely held corporations.100 The offering memorandum also described the terms of the construction loan and furnishings loan as well as construction time and costs.101 Because costs, construction time, and interest rates exceeded those set forth in the offering memorandum, the limited partnership suffered financial difficulty from the beginning. In the fourth month after the Ramada Inn opened, Loftsgaarden sold five additional partnership units to raise $175,000.00 to meet debt payments and requested that the partners make a loan of $125,000.00 to the partnership.102 After Loftsgaarden agreed to step down as general partner, the limited partners continued to make con-

97. Austin v. Loftsgaarden (I), 675 F.2d at 173.
98. Id. The initial offering memorandum suggested that only persons with a net worth in excess of $200,000.00, excluding the values of homes and automobiles, or persons with income taxed at the rate of 50% or more should participate in the investment.
99. Id. at 174. The offering required a minimum investment of $50,000.00.
100. Id. at 174 n.7.
101. Id. at 174-75.
102. Id. at 175-76.
tributions. They also employed an attorney and an accountant to investigate the project. The results of the investigation prompted four of the twenty-two limited partners to file suit.

Following a seven day trial, the jury returned a verdict that Loftsgaarden had knowingly misrepresented and omitted material facts in the offering memorandum and that plaintiffs had relied upon such misrepresentations and omissions, thereby sustaining injury. Based upon these findings, the jury decided that Loftsgaarden had violated section 10(b) of the Exchange Act, the interpretive regulation Rule 10b-5, Chapter 80A of Minnesota's Securities Act, and that he had committed common law fraud as well. The jury also issued an advisory verdict, which the district court accepted, that Loftsgaarden was liable under section 12(2) of the Securities Act. The Eighth Circuit in Austin I affirmed the determination as to liability but remanded the issue of damages, "the most hotly contested issue in ... [the] case."

The trial court entered judgment against Loftsgaarden in the sum of $273,720.00. This award included the amount of the original consideration, prejudgment interest from the purchase date, and an award of attorneys' fees. The court described this as a rescissory remedy. Loftsgaarden attempted to introduce evidence that plaintiffs had incurred no actual loss because they had realized "tangible economic benefit" from "large tax write-offs" generated by the investment. The trial court rejected this evidence, noting that the defendant's argument was "sophistic malarkey."

Loftsgaarden appealed the district court order on the grounds that the trial court had committed reversible error by refusing to admit the evidence related to tax benefits proffered by the defendant. The Austin I court sustained Loftsgaarden's appeal on this argument.

We hold that in a private securities fraud action involving an investment structured and marketed as a tax shelter, where a rescissory measure of damages is applied, evidence of any benefit

103. Id. at 176.
104. Id.
105. Id. at 180.
106. Id. at 172.
107. Id. at 181.
108. Id.
The Eighth Circuit reasoned that this result was proper. First, it held that the federal securities Acts limit a plaintiff's recovery of damages to those amounts actually lost due to reliance on false and misleading representations. The court termed this the "actual damages principle." Traditionally, the court stated, the amount of actual damages had been determined on the basis of an "out-of-pocket measure of damages." The court ruled that a rescissional or restitutional measure of damages should apply because the out-of-pocket rule is "not a talisman" and that Garnatz v. Stifel, Nicolaus & Co., Inc. mandates that the court "fashion a remedy best suited to the harm." The court concluded that any calculation of damages based on a rescissional remedy must reduce the award by the existing or retained value of the security.

Second, the court reasoned that a person invests in a tax shelter because his income is subject to a high rate of taxation and he seeks to protect that income from taxation. To the extent the investor succeeds in accomplishing this result, he realizes value from the investment. Since tax consequences represent a recovery from the security, the value of tax benefits should be subtracted from the award of damages.

On appeal, following remand, the Eighth Circuit Court of Appeals issued two majority opinions in Austin II: (1) a per curiam decision reaffirming Austin I and (2) a panel decision dealing with ancillary issues raised by the trial court's decision on remand. The panel's opinion adds little to an understanding

109. Id. at 183-84.
110. Id. at 180-81.
111. 559 F.2d 1357 (8th Cir. 1977), cert. denied, 435 U.S. 951 (1978).
112. Austin v. Loftsgaarden (I), 675 F.2d at 180-81.
113. Id. at 181.
114. Id. at 182-83. The Austin I court summed up the reasons for requiring a reduction in damages for tax benefits. "[W]e acknowledge the value of the tax deductions generated by such an investment and hold that the strictly compensatory nature of damages awardable in private securities fraud actions requires that such value be taken into account in determining whether and to what extent damages were inflicted upon plaintiffs."
116. Id. at 951-61.
117. Id.
of the issue presented by the case, therefore, it merits no further discussion. The dissenting opinion of Chief Judge Lay, based on the premise that "[r]eliance on precedent is a poor substitute for analysis," is noteworthy because it predicted the ultimate ruling of the United States Supreme Court.\(^{118}\)

The two part per curiam opinion redeclared the Eighth Circuit's commitment to the rule it had established over three years earlier—that tax benefits received by a defrauded tax shelter investor must be subtracted from an award of rescissory damages.\(^{119}\) Initially, the court ruled that the "law of the case doctrine" precluded it from altering its prior decision.\(^{120}\) Nevertheless, it proceeded to echo the rationale of \textit{Austin I} and to reject contrary arguments made by the plaintiffs. The court reasoned that the "actual damages" rule announced in \textit{Austin I} applied to damages awarded pursuant to section 12(2) of the Securities Act and the civil liability provisions of the Minnesota Blue Sky Act\(^{121}\) as well as section 28(a) of the Exchange Act.\(^{122}\) While the majority recognized that the term "actual damages" does not appear in the Securities Act, it reasoned, citing to \textit{Salcer v. Environ Equities Corp.},\(^{123}\) that the remedy provision of section 12 of the Securities Act was intended to place the parties in the \textit{status quo ante} by returning to the plaintiff his net economic loss upon the tender of his securities.

In the eyes of the court, this phrase easily translated into actual damages.\(^{124}\) One can only assume that the court derived

\(^{118}\) Id. at 962-64.

\(^{119}\) Id. at 957.

\(^{120}\) Id. at 952.

\(^{121}\) MINN. STAT. ANN. § 80A.23 (West Supp. 1986).

\(^{122}\) \textit{Austin v. Loftsgaarden (II)}, 768 F.2d at 953-54.


\(^{124}\) \textit{Austin v. Loftsgaarden (II)}, 768 F.2d at 954; see also, \textit{Salcer}, 744 F.2d at 940. In \textit{Salcer} the Second Circuit stated "'[a]ctual damage,' as used in the Exchange Act means 'compensatory damages,'... and hence a plaintiff cannot recover more than his or her 'net economic loss.'" The \textit{Austin II} court's analysis that this language applies to § 12(2) of the Securities Act follows from the court's ruling that the goal of § 12(2) is to return the parties to the \textit{status quo ante}. In order to accomplish this result, the Eighth Circuit reasoned, a plaintiff should only recover his net economic loss, an amount which the court equated with actual damages. The plaintiffs argued in their petition for writ of certiorari before the United States Supreme Court that the actual damage construction applied by the Eighth Circuit ignored the plain language of § 12(2). Petition for Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit at 15, Randall v. Loftsgaarden, 106 S. Ct. 3143 (No. 85-519). (See, micro-fiche collection held by the Law Library at Salmon P. Chase College of Law, Northern Kentucky University).
the net economic loss formula from its interpretation of the "less the amount of any income received thereon" language found in section 12.125

Based on this construction of the actual damages rule, the Eighth Circuit declared that tax benefits received by a defrauded tax shelter investor reduce his economic loss, whether or not they represent income to the investor. In fact, the court admitted that tax benefits are not income in a "strict accounting sense." Nevertheless, it reasoned that economic reality dictates that the receipt of tax benefits reduces the actual harm suffered by the complaining party and should be offset against any recovery. This rationale discloses the court's ends-means approach to solving this issue and its perception that tax deductions are a bargained-for return of value from a tax shelter investment.

Part two of the per curiam opinion explicates the court's ruling in cold hard numbers. On remand, the trial court had followed the mandate of Austin I and had reduced each plaintiff's damage award by the value of tax benefits each claimed from the investment. It had calculated the damage awards according to the following formula: consideration paid plus simple interest of eight percent per annum less tax benefits equals total damages. Pursuant to this formula, the trial court had awarded plaintiff Austin $31,177.00, plaintiff Neuman $39,371.00, plaintiff Randall $31,569.00,

125. Austin v. Loftsgaarden (II), 768 F.2d at 954; 15 U.S.C.A. § 771 (West 1981). The Austin II court does not clearly explain how it construed the damage provisions of § 12(2) of the Securities Act and § 28(a) of the Exchange Act to reach the same result. The structure of the court's argument and its use of terms such as "construe" evince the court's attempt at a statutory interpretation. Unfortunately, the court's lack of logic demonstrates that this analysis is merely a thin disguise for a policy decision.

126. See, 15 U.S.C.A. § 771 (West 1981). The question of whether or not an investor has derived income from an investment arises under a strict application of the damages provision of § 12 of the Securities Act, which requires the reduction of a rescissional award by "any amount of income received thereon." (emphasis added).

127. Austin v. Loftsgaarden (II), 768 F.2d at 955. The Austin II court also ruled that tax benefits are not a return of consideration as argued by the defendant Loftsgaarden. Id. at 958. By forwarding this argument, Loftsgaarden hoped to reduce the amount of damages given as a return of consideration and the amount of damages assessed as interest.

128. Id. at 953-4.

129. Id. at 957. The Court titled section II "How should the plaintiffs' rescissory damages be computed?"

130. Id. at 957.
and plaintiff Anderson $35,172.00.\textsuperscript{131} Loftsgaarden argued on appeal that this simple formula did not satisfy the rule of \textit{Austin I} because it did not account for the yearly gain of tax deductions. He contended that each year's tax consequences reduced the plaintiff's "out-of-pocket" cost and that the tax consequences reduced each plaintiff's outstanding balance of contribution against which prejudgment interest could be charged.\textsuperscript{132}

The Eighth Circuit agreed with Loftsgaarden that the plaintiffs should recover prejudgment interest only against the yearly outstanding balance of their paid-in consideration.\textsuperscript{133} Citing to \textit{Cant v. A. G. Becker & Co.}\textsuperscript{134} and \textit{Chris-Craft Industries, Inc. v. Piper Aircraft Corp.},\textsuperscript{135} the court reasoned that prejudgment interest seeks to compensate plaintiffs for the loss of the use of their money. Since plaintiffs had not been deprived of the entire amount of consideration paid in each year of the project's existence, the award of prejudgment interest should compensate them accordingly.\textsuperscript{136} Adopting the calculations prepared by Loftsgaarden's accountant, the \textit{Austin II} court ordered payment of damages as follows: plaintiff Austin received $3,833; plaintiff Neuman $992; plaintiff Randall $253; and plaintiff Anderson $9,395.\textsuperscript{137}

The dissenting opinion of Chief Judge Lay argued against offsetting rescissory damages by the value of tax benefits for

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\textsuperscript{131.} \textit{Id.} The trial court also awarded attorneys' fees to plaintiffs Neuman and Randall in the respective amounts of $29,000.00 and $20,000.00 pursuant to \textsc{Minn. Stat. Ann.} § 80A.23(2), and costs of $5,321.83 to Austin, Anderson and Nueman, and $2,955.49 to Randall. \textit{Id.} at 952.

\textsuperscript{132.} \textit{Id.} at 958-9.

\textsuperscript{133.} \textit{Id.} In effect, the Court ruled that the receipt of tax benefits are a return of consideration. However, the Court declined to equate the receipt of tax benefits with a return of consideration. \textit{Id.} at 958.

\textsuperscript{134.} 384 F. Supp. 814 (N.D. Ill. 1974). The United States District Court for the Northern District of Illinois opined that prejudgment interest restores to plaintiff the value of beneficial use of his money lost by placing it in the tainted investment. The court stated "[p]laintiff can only be made whole if placed in a posture which assumes that he had the opportunity to utilize his funds in a reasonable manner."


\textsuperscript{136.} \textit{Austin v. Loftsgaarden (II)}, 768 F.2d at 959.

\textsuperscript{137.} \textit{Id.} at 959-60.
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three primary reasons. First, Judge Lay pointed out that the calculation of the value of tax deductions is speculative and inaccurate because it depends upon the taxpayer's tax bracket and other deductions claimed in a given year. Second, he reasoned that the tax benefits received from a tax shelter are usually only deferrals of taxation and that many current deductions are subject to recapture. Finally, Judge Lay opined that reducing a damage award on the basis of tax considerations shifts the burden of loss due to fraud from the fraudulent party, the promoter, to the investor and the government. He further concluded that the IRC does not create income through the grant of a deduction or credit. Therefore, the underlying theme of Judge Lay's opinion was his perception of the IRC as a distinct body of law from securities law.

The Second Circuit and the Ninth Circuit have also decided cases dealing with the issue of the proper measure of damages in a securities fraud action arising out of a tax shelter investment. Following the lead of the Eighth Circuit's Austin I decision, the Second Circuit ruled in Salcer v. Envicon Equities Corp. that the actual damages rule of section 28(a) of the Exchange Act requires a reduction of damages by the value of tax benefits. This decision was based on the restrictive interpretation of "actual damages" as a return of "net economic loss". Like the Eighth circuit, the Salcer court perceived the receipt of tax consequences as a prime motive for purchasing a limited partnership interest. Therefore, any tax benefits generated by the investment are a bargained-for return of economic value and a mitigating factor as to any injury.

Courts in the Ninth circuit have reached the opposite conclusion. The United States District Court for Arizona reasoned in

138. Id. at 962-4.
139. Id.
140. Id.
141. Id.
142. Id. at n.1.
144. 744 F.2d at 935.
145. Id. at 940-1.
146. Id. at 940.
Western Federal Corp. v. Davis that the equitable remedy of rescission seeks to return the parties to the status quo ante and "to work fairness to them."\(^{147}\) The court held that to offset a damages award by the value of tax benefits would enrich a promoter at the expense of the government since it is the government that provides tax incentives.\(^{148}\) The Ninth Circuit Court of Appeals, speaking through Burgess v. Premier Corporation, also resolved the issue in favor of the plaintiff.\(^{149}\) The court awarded rescission and refused to reduce the recovery by the value of tax benefits. The court reasoned that to do so would be inequitable to the plaintiff and leave the "government bearing the cost of defendants' fraud."\(^{150}\) The court concluded that, in light of the tax benefit rule, the tax advantages of the investment are too "illusory" to calculate into a damage award.\(^{151}\)

Prior to the Supreme Court's decision in Randall v. Loftsgaarden, the law on the issue of the proper measure of damages in a tax shelter securities fraud case had revealed the disagreement at the time regarding the character of tax shelter investments. Those jurisdictions that viewed such investments as only a means to escape taxation had required an offset against any award of damages. They regarded the tax consequences as being intrinsic to the investment and the securities. Other jurisdictions had recognized the origin and purpose of the tax features and ruled that damages should not be offset.

**The Supreme Court Decision in Randall v. Loftsgaarden**

A seven member majority of the Court reversed the Eighth Circuit's decision in Austin II and remanded the case for further proceedings.\(^{152}\) Contrary to the lower courts' opinions, the Supreme Court's decision focused on the securities law issues raised by the case as separate and distinct questions from any taxation law concerns.\(^{153}\) Justice Blackmun concurred in the result with the reservation that a different outcome might be dictated if the
investors had complained of misrepresentations going to the tax consequences rather than misrepresentations about the underlying investment. Justice Brennan dissented in an opinion that echoed the arguments of the Eighth Circuit - tax benefits are a bargained-for return of value from a tax shelter investment.

The majority resolved the issues presented by the tax shelter securities fraud case primarily by interpreting the remedy provisions of section 12 of the Securities Act and section 28(a) of the Exchange Act. The Court ultimately held that section 28(a) does not require the value of tax benefits to be offset against a rescissory damages award granted under section 12(2) of the Securities Act or section 10(b) of the Exchange Act. Before it reached this final conclusion, the Court ruled that tax benefits received from an investment are not income or a return of consideration for purposes of section 12 of the Securities Act.

The majority set forth three reasons why tax benefits received from the investment scheme offered by Loftsgaarden should not reduce a damages award under section 12(2). First, the Court invoked the plain language canon of statutory interpretation to support its ruling that the term "income received" in section 12 of the Securities Act does not include receipt of tax benefits. As dictated by precedent, the Court applied the plain language canon to restrict expansion of the statutory language. Also, by using this canon, the Court avoided consideration of the public policy concerns which influenced Congress' use of the term.

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154. Id. at 3155.
155. Id. at 3157.
156. Id. at 3155.
157. Id. at 3150.
158. See, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201, 214 (1976), reh. denied, 425 U.S. 986 (1976). In Hochfelder the Supreme Court invoked the plain language rule of statutory construction to restrict expansion of § 10(b) and Rule 10b-5 to only apply in cases where a plaintiff can show negligent misrepresentation in regard to the sale of a security. The Court reasoned that the language of § 10(b) "clearly connotes intentional misconduct" through use of the terms 'manipulative' and 'deceptive.' The Court also considered the Exchange Act's legislative history in reaching the result that a court must find that the fraudulent party acted with scienter in order to establish liability under § 10(b) and Rule 10b-5.
159. See, Aaron v. Securities and Exchange Commission, 446 U.S. 680, 695 (1980). Citing to Ernst & Ernst v. Hochfelder, the Supreme Court in Aaron ruled that § 17(a) of the Securities Act requires an element of scienter in order to find liability. In reaching this result, the Court reasoned that the language of the statute could be interpreted to reach this result without reference to the Act's legislative history.
Arguably, the Court attempted to define the term "income" as used in the statute to exclude tax deductions. While this may have been the focus of the Court's opinion, the Court seems to have been more concerned with interpreting the phrase "income received thereon." The Court reasoned that the value of tax deductions and tax credits cannot truly be considered as resulting from ownership of a particular security. Rather, it regarded tax consequences as deriving value from their effect on a taxpayer's overall economic position. Absent substantial income against which to subtract a deduction or credit, a taxpayer cannot utilize, or gain value from, an item's deductibility. Therefore, the Court concluded, unlike the receipt of a dividend on stock, interest on bonds, or a limited partner's distributive share of profits or income, the value of a tax deduction is not received on the security. Tax consequences derive value from sources independent of the security—the IRC and other income.

Secondly, the Court rejected Loftsgaarden's argument that the equitable nature of the remedy of rescission requires the deduction of tax benefits from the damages award. Loftsgaarden had urged that rescission requires the plaintiff to return to the other party any value he received through purchase of the security. After chastising Loftsgaarden for having made unsupported assertions, the Court ruled that his interpretation of the remedy of rescission was inaccurate. The inaccuracy, said the Court, resulted from his failure to recognize the application of the "direct product" rule. Citing to the Restatement of Restitution, subsection 157, the Court noted that rescission does not require the return of all value derived from the investment. The direct product rule requires the plaintiff to return only amounts received from other than an independent transaction. Tax conse-

160. Randall v. Loftsgaarden, 106 S. Ct. at 3150. The Court states, "the 'receipt' of tax deductions or credits is not itself a taxable event, for the investor has received no money or other 'income' within the meaning of the Internal Revenue Code."
161. Id.
162. Id.
163. Id. at 3151.
164. Restatement of Restitution § 157 (1962). The Restatement reads: "(1) A person under a duty to another to make restitution of property received by him or of its value is under a duty (a) to account for the direct product of the subject matter received while in his possession . . . ." Comment b of this section states that "[t]he phrase 'direct product' means that which is derived from the ownership or possession of the property without the intervention of an independent transaction by the possessor."
quences, the Court opined, are not the direct product of the investment because they are created by the Government.165

Finally, the Supreme Court rejected Loftsgaarden's argument on the basis that Congress had intended the rescissionary remedy to do more than return the parties to the status quo.166 In the Court's view, Congress had intended the Securities Act to not only compensate an injured plaintiff for losses suffered, but also to "deter prospectus fraud and encourage full disclosure."167 Therefore, it concluded that the interpretation of the intended remedy offered by Loftsgaarden would negate the remedial purpose of the Act.168

In Austin II, the Eighth Circuit had essentially ruled that the actual damages rule of section 28(a) controls any rescissionary remedy under section 12(2) of the Securities Act.169 The court cited the case of Globus v. Law Research Services, Inc. in support of this position.170 The Supreme Court rejected this ruling on the grounds that to permit section 28(a), a subsequent statute, to control the results obtainable under section 12(2) would constitute a repeal of the prior statute by implication. The Court opined that the law does not favor a repeal by implication unless the two statutes irreconcilably conflict or unless the later act "covers the whole situation of the earlier one and is clearly intended as a substitute."171

While the actual damages provision of section 28(a) does not control the remedy available under section 12(2), the reverse of this statement is not necessarily true.172 The Court discussed the issue as to whether section 28(a) provides for a rescissionary measure of damages, but it declined to decide the issue because the petitioners had agreed that such a remedy may be available under section 28(a).173 Nevertheless, in order to clearly define the

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165. Randall v. Loftsgaarden, 106 S. Ct. at 3151.
166. Id.
167. Id.
168. Id.
169. Austin v. Loftsgaarden II, 678 F.2d at 953-4; see also, infra notes 117, 118 and accompanying text.
170. 418 F.2d 1276 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970). In Globus the Court ruled that § 17(a) of the Securities Act is substantially equivalent to § 10(b) of the Exchange Act. This ruling precluded an award of punitive damages under § 17(a).
171. Randall v. Loftsgaarden, 106 S. Ct. at 3152.
172. Id. at 3153.
173. Id.; Salcer v. Environ Equities Corp., 744 F.2d 995, vacated, 106 S. Ct. 3724 (July
proper measure of rescissionary damages to apply in the case
_sub judice_, the Court discussed, _arguendo_, the scope of rescission
under section 28(a). Since that section specifically restricts a
plaintiff’s recovery to actual damages, the Court felt compelled
to define actual damages in relation to a rescissionary remedy.\footnote{174}

The issue, of course, was whether a rescissionary award under
the actual damages rule of section 28(a) should be reduced by
the value of tax benefits. To aid the Court’s definitional process,
it looked to the meaning of “actual damages” at the time the
Exchange Act was enacted.\footnote{175} Having determined only paragraphs
before that Congress had not intended the rescission remedy to
require a reduction of the damages award, the Court found a
“conspicuous example of a rescissionary remedy.”\footnote{176} Therefore,
the rescissionary remedy available under section 28(a) could not
be interpreted, relative to section 12(2), to require a reduction of
damages by the value of any tax benefits received.

Consistent with the Court’s argument against offsetting a civil
liabilities award under section 12(2), it proceeded to argue that
Congress had intended the remedies provided under the Ex-
change Act to perform a remedial function.\footnote{177} Reducing the award
by the value of tax benefits received would, therefore, subvert
the Act’s underlying purpose of deterring fraud and manipulative
practices in the securities markets.\footnote{178} The Court stated that “[t]his
deterrent purpose is ill-served by a too rigid insistence on limiting
plaintiffs to recovery of their ‘net economic loss.’”\footnote{179} Any offset
for tax benefits would tend to “insulate” the fraudulent party
from a law suit by removing the investor’s incentive to seek
reparation.\footnote{180}

Further, the majority reasoned that the interpretation of sec-
tion 28(a) suggested by Loftsgaarden was not supported by prec-

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\footnote{7, 1986]. _Salcer_ was litigated primarily as a violation of § 10(b) and Rule 10b-5 with the
plaintiff seeking rescissionary damages. The Second Circuit ruled that _Austin I_ required
an offset for tax benefits in any tax shelter case in which plaintiffs seek rescission. The
Supreme Court vacated the decision of the Second Circuit and remanded the case for
proceedings consistent with _Randall v. Loftsgaarden_, 106 S. Ct. 3143.

\footnote{174}. _Randall v. Loftsgaarden_, 106 S. Ct. at 3153.

\footnote{175}. Id.

\footnote{176}. Id.

\footnote{177}. Id. at 3154.

\footnote{178}. Id.

\footnote{179}. Id.

\footnote{180}. Id.
edent. The Court recognized that prior decisions had restricted a section 28(a) recovery to a plaintiff's actual damages.\textsuperscript{181} It noted that in \textit{Affiliated Ute Citizens v. United States}\textsuperscript{182} the Court had determined the plaintiff's damages to be the "amount of the defendant's profit."\textsuperscript{183} Citing to \textit{Janigan v. Taylor},\textsuperscript{184} it further reasoned that the remedy counseled by \textit{Affiliated Ute Citizens} supported the Act's goal of preventing a fraudulent party from realizing an unjust enrichment to the detriment of the injured party.\textsuperscript{185} In the Court's opinion, therefore, these precedents called for a flexible approach to measuring damages under the actual-damages principle of section 28(a) rather than the restrictive rule suggested by \textit{Loftsgaarden}.

The Court also expressed its opinion that the tax benefit rule ratified by \textit{Hillsboro National Bank v. Commissioner}\textsuperscript{186} would reduce any potential windfall a plaintiff might receive as a result of not deducting tax benefits from the damage award.\textsuperscript{187} The tax benefit rule requires a taxpayer to include in gross income any amounts recovered from an item deducted in a previous year if

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\textsuperscript{181} Id. at 3153 (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), reh. denied, 423 U.S. 884 (1975)).

\textsuperscript{182} 406 U.S. 128 (1972). At page 155 of the \textit{Affiliated Ute Citizens} case the Court states: "In our view, the correct measure of damages under § 28 of the Act ... is the difference between the fair value of all that the mixed-blood seller received and the fair value of what he would have received had there been no fraudulent conduct, (cite omitted) except for the situation where the defendant received more than the seller's actual loss. In the latter case damages are the amount of the defendant's profit (cite omitted)."

\textsuperscript{183} Randall v. Loftsgaarden, 106 S. Ct. at 3153.

\textsuperscript{184} 344 F.2d 781 (1st Cir. 1965), cert. denied, 382 U.S. 879 (1965). In \textit{Janigan} the Court distinguished between a defrauded buyer and a defrauded seller and applied a separate remedy to each injured party. The \textit{Janigan} Court ruled that a defrauded buyer should only receive the difference between the price paid and the securities' fair market value at the date of purchase, plus interest and any expenditures attributable to the fraudulent party's conduct. The \textit{Janigan} Court developed a less restrictive measure of damages to be applied in the case of a defrauded seller. A defrauded seller should recover any profit made by the purchaser because, "[i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them."

\textsuperscript{185} Randall v. Loftsgaarden, 106 S. Ct. at 3153.

\textsuperscript{186} 460 U.S. 370 (1983). In the \textit{Hillsboro National Bank} case, the Court opined that the tax benefit rule aims to produce a tax system based on transactional accounting. The rule cancels out prior deductions when a latter event occurs that is "fundamentally inconsistent with the premise on which the deduction was based." \textit{Id.} at 383. The tax benefit rule requires the taxpayer to recognize unexpected recoveries on subsequent year's returns. \textit{Id.} at 379.

\textsuperscript{187} Randall v. Loftsgaarden, 106 S. Ct. at 3154.
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that deduction results in a reduction of tax liability.\textsuperscript{188} The rule does not reopen the previous year’s return, but requires that any recovery be reported in the year it is realized.\textsuperscript{189} Therefore, the Randall Court concluded, the complex provisions of the IRC are better suited to prevent an excessive windfall recovery than any reduction in the award by the trial court.\textsuperscript{190}

The Court also rejected Loftsgaarden’s argument because it would require the use of elaborate methods for calculating damages.\textsuperscript{191} Under Loftsgaarden’s approach, a jury would be required to delve into an investor’s business affairs and tax history in order to determine the exact value of any tax deductions. The Court ruled that section 28(a) does not require such a complex inquiry.\textsuperscript{192} This rule seems to conflict with the Court’s decision in \emph{Norfolk & Western Railway Co. v. Liepelt,}\textsuperscript{193} but the Court did not overrule that decision.\textsuperscript{194}

Finally, the majority reasoned that tax losses are not an aspect of the security purchased by the investor.\textsuperscript{195} Unlike a security, tax consequences are not freely transferable, but are intended by Congress to be personal to the taxpayer. Therefore, it deferred to the authority of Congress to amend the securities laws to accommodate Loftsgaarden’s “version of economic reality.”\textsuperscript{196} Justice Blackmun concurred with the majority’s decision that when a tax shelter investor seeks rescission due to misrepresentations concerning the underlying investment, the damages award should not be reduced by the value of tax benefits generated by the investment.\textsuperscript{197} However, Justice Blackmun suggested that if rescission is not a proper remedy for a defrauded tax shelter

\begin{itemize}
  \item \textsuperscript{188} J. DOHENY & M. WEINSTEIN, MERTENS: LAW OF FEDERAL INCOME TAXATION § 7.34, vol. 1, ch. 7, at 114-21.
  \item \textsuperscript{189} Id., ch. 7, at 115.
  \item \textsuperscript{190} Randall v. Loftsgaarden, 106 S. Ct. at 3154.
  \item \textsuperscript{191} Id.
  \item \textsuperscript{192} Id.
  \item \textsuperscript{193} 444 U.S. 490 (1980). In the \emph{Norfolk & Western Ry. Co.} case, the Court held in a wrongful death action brought pursuant to the Federal Employees Liability Act that the trial court should admit evidence offered by the defendant to show the effect of income taxes on the decedent’s future income potential. In this regard, the Court found that the evidence concerning potential income taxation was not too complex or speculative for a jury to consider.
  \item \textsuperscript{194} Randall v. Loftsgaarden, 106 S. Ct. at 3154.
  \item \textsuperscript{195} Id. at 3155.
  \item \textsuperscript{196} Id.
  \item \textsuperscript{197} Id. at 3155-6.
\end{itemize}
investor, the out-of-pocket measure of damages normally applied in section 10(b) cases should account for tax benefits. Applying a rationale similar to that of Justice Brennan's dissenting opinion, Justice Blackmun concluded that the tax benefits are a bargained for aspect of the purchase price which, if returned, reduce an investor's out-of-pocket losses.\footnote{198}

Justice Brennan's dissent argued to uphold the decision of the Eighth Circuit on the same rationale that had been adopted by that court.\footnote{199} In short, Justice Brennan reasoned that the remedy of rescission required by section 12(2) "entails the undoing of the original transaction and restitution involves the restoration of each party to his pre-contract position."\footnote{200} The common law application of this remedy called for each party to return to the other those items originally bargained for, plus any gain on those items. Since tax benefits were a bargained for return of value on the investment, they must be returned to the seller.\footnote{201} Justice Brennan reasoned that Congress had not intended to ignore the economics of taxation when it adopted the rescission remedy for use in section 12(2).\footnote{202} While the dissent offered no new analysis of the issue, Justice Brennan did present a persuasive argument.

\textbf{Analysis and Conclusion}

Ultimately, the decision of \textit{Randall v. Loftsgaarden} only resolved the issue as to whether the federal securities laws recognize tax consequences as a gain or loss of income, or as a return of consideration, for the purpose of measuring damages in a civil action. The Court's narrow holding stated that the plain language, structure, and legislative history of the federal statutes precluded offsetting a damages award to a defrauded tax shelter investor by the value of any tax benefits he may have received. Yet, the breadth of the opinion offered a definition of the nature of a tax shelter investment, the relationship of the parties to one another, and their relationship to the IRS.

By rejecting the "economic reality" argument advanced by Loftsgaarden, the Court divided the concept of a tax shelter

\footnotesize\textit{Id. at} \textit{3156-7.}
\footnotesize\textit{Id. at} \textit{3157-9.}
\footnotesize\textit{Id. at} \textit{3157.}
\footnotesize\textit{Id. at} \textit{3158.}
\footnotesize\textit{Id.}
investment into two component parts: the ownership of a security, and the offering of favorable tax consequences. The ruling recognized, by implication, that a profitable tax shelter investment requires more than favorable tax consequences. A profitable tax shelter, like any other investment, requires careful, honest attention to the economic prospects of a favorable return from the underlying venture. This implication follows from the Court’s decision which supported a defrauded investor’s right to seek damages from a promoter pursuant to the securities laws absent consideration of tax consequences of the investment. Tax considerations, the Court ruled, are not the product of the security or the promoter. Rather, they are creations of the government that depend upon the individual taxpayer’s overall economic position for their effect.203

While Randall v. Loftsgaarden had a substantial impact upon the area of tax shelter investments, its true precedential value may lie in its analysis addressing the measure of damages applicable to suits brought under section 12(2) of the Securities Act and section 10(b) of the Exchange Act and Rule 10b-5. The appropriate remedy for securities civil liability or fraud cases has remained largely unsettled.204 Great uncertainty has surrounded the issue of what measure of damages a court should apply with respect to a given form of remedy.205 The limited scope of remedies available under section 12(2) of the Securities Act, and the Act’s prescription for their usage, helps to reduce the problem to some extent.206 However, under their section 10(b) and Rule 10b-5 authority courts have tailored available private remedies to fit a particular harm by varying the measure of damages.207 This approach has worked to prevent resolution of the issue because injured parties have chosen to settle their claims rather than submit them to the vagaries of such unbridled discretion. As a result, courts have had few opportunities to rule

203. See infra notes 10-31.
205. Mullaney, supra note 204 at 277-81.
206. See generally, Peterson, Recent Developments in Civil Liability Under Section 12(2) of the Securities Act of 1933, 5 Hous. L. Rev. 274 (1967).
on the issue.208 The decision in Randall v. Loftsgaarden expressed the Supreme Court's approach to defining the available remedies and measure of damages.

The decision in Randall v. Loftsgaarden proceeded from the premise that Congress had passed the securities laws to deter fraudulent and manipulative conduct in the offering and exchange of securities as well as to compensate investors who sustain economic injury as a result of deceptive practices. The history of the Acts reflects, as the Supreme Court has recognized, that the fundamental purpose behind the federal securities laws is to "substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry."209 The remedial purpose of the Acts dictates that courts should formulate the proper remedy on a case-by-case basis.210

The Court in Randall v. Loftsgaarden reaffirmed the remedial purpose of the Acts and suggested an approach to determining the measure of damages that should encourage enforcement of the securities laws through private actions. Throughout its opinion the court expressed the concern that an investor should have incentive to bring suit under the Securities Acts. The majority reasoned that if a plaintiff's recovery were to be depleted by an offset for tax benefits, he would not be as willing to incur large legal fees to enforce his right to make informed investments.211

The decision in Randall v. Loftsgaarden did not depart from the rule of J. I. Case Co. v. Borak,212 but, rather, expanded upon its principle. The majority reasoned that the Securities Acts aim

208. Jacobs, supra note 204 at 1094-5.
210. See, J.I. Case Co. v. Borak, 377 U.S. 426 (1964). In answer to the question of whether §27 of the Exchange Act (15 U.S.C.A. § 78aa (West, 1982)) authorizes a civil remedy for violation of §14(a) of that Act (15 U.S.C.A. § 78n (West Supp. 1986)) the Court stated: "We, therefore, believe that under the circumstances here it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose.... It is for the federal courts 'to adjust their remedies so as to grant the necessary relief where federally secured rights are invaded.' And it is also well settled that where legal rights have been invaded, and a federal statute provides for a general right to sue for such invasion, federal courts may use any available remedy to make good the wrong done." 377 U.S. at 433.
211. Randall v. Loftsgaarden, 106 S. Ct. at 3154.
to restore an injured party to a position at least equivalent to that held prior to entering the investment. Further, the Court reasoned that the Acts intended to impose any loss resulting from a deceit or manipulation upon the acting party. In support of this approach, the Court relied upon the remedy provisions of Affiliated Ute Citizens v. United States213 and Janigan v. Taylor.214 The Court affirmed the rule of Affiliated Ute Citizens that a plaintiff's right to recover for injury caused by a defendant's fraud takes precedence over any concern that he might receive a windfall from the award.215 The Court proceeded to expand the rule of Janigan v. Taylor to apply not only in the situation where a seller of securities is defrauded but also where a purchaser of securities is defrauded.216 Therefore, any windfalls which might result from a damage award in a securities civil action will flow to the injured party regardless of his position as a seller or purchaser of securities.

In Randall v. Loftsgaarden the majority of the Supreme Court expressed its opinion as to the appropriate method of resolution of the issues presented by tax shelters as investments more than it offered clear, brightline rules. Yet, it made clear that a tax shelter promoter will not be excused of his fraud and manipulation merely because his deal has produced some tax value. In fact, the Court encouraged defrauded tax shelter investors to prosecute any claim of fraud under the Securities Acts by holding out the carrot of a potential windfall.

213. 406 U.S. 128.
214. 344 F.2d 781 (1st Cir. 1965), cert. denied, 382 U.S. 879 (1965).
216. See supra note 177.
For many years in Kentucky the official transcripts of jury and nonjury trials have been made by court reporters. Some court reporters take shorthand while others use a stenotype machine. More recently, court reporters have used tape recorders as a backup device. Whatever system was used, following the trial, the court reporter prepared the official typed transcript of the trial. The record on appeal usually consisted of the pleadings, motions, exhibits, and most importantly, the typed transcript of the testimony.

In 1981, the Supreme Court of Kentucky ordered six trial courts, five of which were located in Louisville, to make videotape recordings the official transcript or record of a trial. Some delay in the implementation of the new system occurred because of difficulties in procuring a videotape recorder that performed satisfactorily. This was done on an experimental basis to evaluate the effectiveness of videotaping as compared to the conventional methods of reporting trials. In 1985, the National Center for State Courts evaluated the videotaping system. This analysis was done on a “cost-benefit” basis. The report concluded that videotaping trials was a more cost-effective way of reporting trials than the previously used techniques. Because the National Center for State Courts concluded that videotaping trials was preferable to conventional methods, and because the new system has been favorably received by judges who have used it, one would

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1. See KY. R. Civ. P. 75.01.
2. Id. at 75.07.
4. NATIONAL CENTER FOR STATE COURTS, AN EVALUATION OF KENTUCKY'S INNOVATIVE APPROACH TO MAKING A VIDEOTAPE RECORD OF TRIAL COURT PROCEEDINGS, at 63, April 29, 1985.
assume that other jurisdictions will soon experiment with the system.

This article comments on the new system from the point of view of the various participants in a trial, i.e., the witnesses, jury, attorneys, and the trial or appellate court judges. What follows is not a "scientific" analysis. The system has not had sufficient use to permit more than rather tentative conclusions. The author's opinions are based on his own experience in handling cases, observing cases being tried, and conversations with attorneys, judges, and witnesses.

The videotaping system being used in Kentucky is activated by sound. The cornerstone of the system is a device which is capable of switching several cameras and microphones on and off depending on whether the judge, an attorney, or a witness is speaking. Thus, a person sitting in the witness chair who answers a question will instantly be picked up by a camera directed toward the witness stand. If the judge makes a comment at the bench, the switching device will activate a camera focused on him. If two or more people speak at once, a wide angle camera will be activated which gives a view of the entire courtroom. The audio portion of the system can record and play back two or more people speaking simultaneously. The courts using this system have a camera and microphone in the judges' chambers. The judges' chambers are also equipped with a visual and audio courtroom monitor.

Because there is no court reporter in the courtroom making a verbatim record of the proceedings, the judge is responsible for the operation of the system. Each morning the judge turns on the monitors, checks each microphone to see if the system is picking up the sound, and switches the cameras to the different locations in the courtroom. This is done by making some kind of noise near each microphone and observing the video monitor to see that the proper camera is recording.

The judge then inserts two new videocassettes into the two video camera recorders (VCRs). The two videotaped recordings become the official record of the trial. The judge then presses the record buttons on the VCRs and the system is activated. During a trial the judge listens to and watches his monitor and panel to see if the voices of attorneys and witnesses are being recorded.

When there is a conference at the bench during a trial, the judge presses a "mute button" so that the jury will not overhear
the conversation which would otherwise be amplified throughout the courtroom. However, the voices of the judge and attorneys are still recorded. A conference in chambers can also be placed on the record. To do this, the judge activates a switch which turns on the camera and microphone in chambers. The conference is then recorded on the VCRs but those in the courtroom will not hear it. After the conference, the judge presses a switch to reactivate the system in the courtroom.

As the trial progresses, the presiding judge manually fills out a "trial log." The recording system has a timing device which constantly records on the videotape the exact time, i.e., day, hour, minute, and second. The judge is responsible for noting on the trial log the times at which the various events occur during the trial such as voir dire, the swearing in of the jury panel, opening statements, instructions to the jury, closing statements, jury verdict, dismissal of the jury, and when the proceedings terminate. There are separate log sheets on which to record the exact time when witnesses begin and end direct, cross, redirect and re-cross examination, and when exhibits are presented. If all or part of a deposition is entered in evidence, either the transcript of the deposition or the videotape recording of the deposition may be the official record. At the completion of the trial, the judge marks all tapes and stores them with the logs of the proceedings together with the exhibits in the court clerk's office. No judge complained to the author that the operation of the video equipment and keeping the trial log was burdensome or distracting to him.

For the purposes of appeal, the two videotape recordings made during the trial become the official record. When a written notice of appeal is filed, one of the video tapes is sent to the clerk of the appeals court. The other tape remains with the clerk of the trial court. The clerk of the trial court arranges for making duplicate recordings for use by counsel in preparing briefs. The cost of each duplicate tape is $15. Normally, no typed transcript is made from the videotape. The clerk of the trial court prepares the record on appeal in much the same way that it is presently done under conventional practice. The clerk is also directed to make duplicate videotapes at a cost of $15 for each duplicate

6. Id. at 1.
requested. Exhibits are arranged in the order presented and a general index is made for each volume of the record. 7

With the courts videotaping trials, one must ask what, if any, impact this has had or will have on the way an attorney prepares his client, witnesses, and himself for trial? When the system was initially installed there was concern that attorneys would need to become actors and that witnesses would have to be trained on how to behave before the camera. Having observed the system work for several years and discussing the subject with attorneys and judges, this author notes little difference in the way that cases are being prepared and presented under the new system. Many law firms have used video equipment for years to help witnesses and counsel create the most favorable impression before a jury. Since the introduction of the new videotape system, these firms have done little different in preparing their witnesses for trial. The witness preparation that takes place in law offices is done by the members of the firm, with no assistance from people with video production skills. The major reason for the lack of change in the style of trying cases is that trial attorneys are first and foremost concerned with winning at the trial level. In a jury trial, it is more important that the witnesses make a favorable impression on the jury than on the camera. Trial attorneys know that less than twenty percent of jury verdicts are overturned on appeal. Hence, trial attorneys direct their attention toward persuading the jury, not the appeals court.

In fact, with the way the courtrooms are constructed in Louisville, witnesses do not look directly into the camera. The witness stand is located at one end and slightly in front of the jury box. The attorney usually stands at the opposite end of the jury box and questions the witness from there to facilitate the witness' eye contact with both the jury and himself.

The requirement to persuade the jury, while accommodating to the physical layout of courtrooms and the positioning of the cameras has made little difference in the way witnesses present themselves under the new system. Witnesses usually forget that they are being videotaped after they have been on the witness stand a short time. The video equipment is considerably less noticeable to a witness than was a court reporter. With the use

7. Id. at 3.
of the video system, the witness need never be asked by a court reporter to repeat testimony, or to speak louder or more slowly. The size of the cameras and microphones is small. There is general agreement that the new system is less intrusive than court reporters. What effect has the new system had on the conduct of lawyers? Surprisingly little. It is still important for an attorney to direct his factual arguments to the jury and his legal arguments to the trial judge. However, now he might also wish to consider the effect of his presentation upon the video camera and the appeals court. After observing numerous trials conducted in front of the video camera, however, it was interesting to note that most attorneys, after the trial was under way, forgot that they were being videotaped. For example, when an attorney presented an exhibit to the jury or wrote something on the blackboard, the judge sometimes had to remind him to place the blackboard or exhibit in a place where the judge, jury and camera could see it.

Even though there have been few changes in the way attorneys act in court or prepare their witnesses for trial, there have been some minor changes in the way attorneys write their appellate briefs under the videosystem. For example, in writing a brief from a videotape record a different method is used to cite to the record. Instead of citing to a particular page in the transcript, attorneys must now set forth the number of the videotape, as well as the month, day, year, hour, minute, and second at which the reference begins as recorded on the videotape. Attorneys may also attach to their brief an evidentiary appendix, which contains transcriptions of those parts of the videotape that support specific issues or contentions raised in the brief on appeal or that relate to the question of whether an alleged error was properly preserved for appellate review. Thus, preparing a brief on appeal is not radically different under the new system. The attorney must replay the tape in order to locate pertinent portions of testimony for citation in his brief. The form and content of his brief largely remains the same. In some respects, the preparation of a brief on appeal may be easier under the new system. For example, there is no delay in waiting for a transcript to be prepared. Duplicate videotapes are easily obtained, relatively inexpensive, and the cassettes can be reused.

8. Id. at 5.
Perhaps the most significant change that will result from videotaped trials will occur at the appellate level. Two points should be developed here. First, videotaped trials provide a means by which an appellate court can and must pass on the nonverbal communication that occurs in a trial. Second, an appeals court will have a much better tool at its disposal with which to make credibility determinations. The videotape provides an appeals court with a tool it can use to reverse trial courts for a variety of misconduct which would not show up in a transcript. If an attorney badgers and intimidates a witness, the appeals court can hear the attorney's tone of voice, as well as see his demeanor, neither of which would be discernible from a printed record. If a trial judge is inattentive or nods negatively in disbelief at something a witness says, an appeals court could watch the tape and observe such misconduct. A "skillful" or "dedicated" court reporter can no longer omit from a printed transcript offhand remarks that are sometimes made by attorneys or the judge during a trial. Clearly, everyone's behavior can be more carefully scrutinized with the use of a videotape than with a printed transcript. It cannot be said, as of this writing, whether or how the Kentucky Supreme Court will use the videotape record to supervise more closely the conduct of trial attorneys and judges.

Somewhat troubling is the prospect that appeals court judges will, without a formal change in the law, or without admitting that they are doing so, make credibility judgments which have traditionally been reserved for the trier of facts. Traditionally, the jury resolves disputed factual issues and makes credibility determinations. Under Rule 52 of the Kentucky Rules of Civil Procedure, the findings of a trial court sitting without a jury, should not be reversed unless they are determined to be "clearly erroneous." Due regard should be given to the opportunity of the jury or the trial court to hear the evidence and observe the demeanor of the witnesses so as to judge their credibility.9 Under this rule, the appeals court cannot substitute its judgment for the jury on the contested issues of fact when the jury's findings are supported by substantial evidence of probative value.10

9. See Ky. R. Civ. P. 52.01.
Now that appeals court judges have a videotape of the trial, however, they are in a position to observe the demeanor of witnesses. Appeals court judges could become finders of fact and judges of credibility. It will require considerable discipline for an appeals court judge to watch a witness on videotape, conclude in his own mind that the witness should not be believed and then write an opinion which credits the testimony of that witness on the basis that the jury believed him or her. Clearly, appellate courts have a new tool in the videotape record for expanding the scope of judicial review of credibility determinations. As of this writing it cannot be said whether appeals court judges in Kentucky have changed the way in which they apply the "clearly erroneous" standard. At this point, the videotaping system has been described as a system that has worked well and created few problems. However, there are potential problems with the system. For example, what happens if the system fails to record the court when it takes guilty pleas? Or, suppose the judge forgets to press the "mute" button when hearing arguments on the admissibility of evidence, discussing a party's motion for a mistrial, or when he is hearing arguments on the voluntariness of a confession. It is error for such discussions to be heard or considered by a jury. An attorney may not learn of such a malfunction in the system until it is too late to raise the issue before the trial judge. Some of these kinds of errors traditionally have not been reviewed on appeal unless the error was first argued to the trial judge.

It could also occur that, during a recess, the judge could retire to his chambers and accidentally (or not accidentally) overhear conversations between an attorney and his client in the courtroom which the attorney and client thought were confidential because no one else was in the courtroom. Anyone in the courtroom who makes a sharp noise, such as tapping a pencil on a wooden table, can cause the camera to focus on the microphone nearest the sharp noise. The contempt power judges now possess should be adequate to deal with most of these situations. Many, however, remain to be resolved.

Conclusions

The general question as to whether videotaping trials is a better system than traditional court reporting involves many considerations that are beyond the scope of this article. It is safe
to say that videotaping trials has not made a radical difference in the way cases are prepared and tried in the six Kentucky courts where the system is currently being used. Certainly a videotape of a trial could be very useful for an attorney to use in improving his own skills. One would also suppose that a videotape would reduce the amount of, or at least make reviewable, non-verbal misconduct. It remains to be seen whether appeals courts will enlarge the scope of review when the record is a videotape as opposed to a printed transcript. Finally, it cannot be said that the system is foolproof or free from all abuse.
PROVIDE FOR THE COMMON DEFENSE: THE CONSTITUTION OF THE UNITED STATES AND ITS MILITARY SIGNIFICANCE

Paul Brickner*

When the delegates to the Federal Constitutional Convention gathered in Philadelphia on May 25, 1787, their charge from the Annapolis Convention of 1786¹ and the Congress of the Articles of Confederation was to revise the existing Articles.² When they adjourned on September 17, 1787, they had signed an entirely new Constitution.³ The new Constitution was, by the words of its preamble, designed "to form a more perfect union, establish justice, insure domestic tranquility, provide for the common defense, promote the general welfare, and secure the blessing of liberty to ourselves and our posterity."* On June 21, 1788, having been ratified by the required nine states, the document became the supreme law of the land.⁵

Today, in 1988, the second of a five year celebration of the bicentennial of our Constitution of 1787 and the Bill of Rights of 1791, we might benefit by being particularly attentive to those parts of our nation's charter that provide "for the common defense." The courts and major commentators have recognized the relationship of these basic military provisions to the very survival of Constitutional government, and have assembled a substantial body of case law, precedent, and wisdom in this important area.


³. C. Bowen, supra note 2, at 225.
⁴. U.S. Const. preamble (emphasis added).
⁵. R. Shnayerson, The Illustrated History of the Supreme Court of the United States 53 (incorrectly stating the date as Sept. 13), 227 (1986).
THE CONSTITUTION AND HUMAN NATURE

James Madison wrote of checks and balances in *The Federalist*, noting that "If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary." In concluding that government should be divided into different branches, Madison spoke of countering ambition with ambition. "It may be a reflection on human nature that such devices should be necessary to control the abuse of government. But what is government itself, but the greatest of all reflections on human nature?"

Professor Benjamin F. Wright has noted that even though Madison and Alexander Hamilton differed markedly in their views of government, both seemed to share a common understanding of human motivations and human nature. The authors of *The Federalist* believed that "[m]en are not to be trusted with power, because they are selfish, passionate, full of whims, caprices, and prejudices. Men are not fully rational, calm, or dispassionate."

Numerous studies have been published in recent years dealing with the human tendency toward aggression. War and military power constitute its ultimate expression. But even without the benefit of these studies, the founding fathers recognized this fact and dealt with it. Our Constitution was molded in the aftermath of years of combat with England. Given the social viewpoint of the authors of *The Federalist* and this immediate history, the military preparedness provisions "for the common defense" must have had high priority for them. Similarly, given their view of human nature, their provision for a process of impeachment was also predictable. This concept was not new to the early Americans, having been adopted from English law. Washington, Jefferson, Hamilton, and Jay all faced attempts to impeach them during their careers. For Jefferson,

7. Id.
8. Id. at 27 (introduction by B. Wright).
the attempt was based on his alleged incompetence as Governor of Virginia.\textsuperscript{10}

Human aggression is well known to be a factor in virtually every aspect of human endeavor. For example, we lawyers conduct our professional activities within the framework of the adversary system. “[P]ersons with conflicting stakes in an outcome ... put the system into motion and ... bring to the attention of the trier all necessary facts and arguments.”\textsuperscript{11}

Major trials are often monumental fights. The adversary system, therefore, can be thought of as a means of sublimating human aggression and resolving disputes in a civilized manner. The courtroom replaces the street or back alley as the battlefield. This Perry Mason “warrior of the courtroom” image is precisely what attracts many college students to the law. Students with more passive personalities tend to choose other professions.\textsuperscript{12}

Justice Brandeis demonstrated this adversarial characteristic in his personality. His childhood memories of Louisville included recollections of soldiers he had seen there during the Civil War.\textsuperscript{13} Years later, while in law school, he wrote that during his earlier studies in Germany he had “wanted to go back to America ... to study law. My uncle, the abolitionist, was a lawyer; and to me nothing else seemed really worth while.”\textsuperscript{14}

It was the adversarial role of the legal profession that appealed to young Louis Brandeis.\textsuperscript{15} Indeed, in his career as a practicing lawyer, he was called “the people’s attorney.” Brandeis himself summed it all up with a revealing comment, “I would rather fight than eat.”\textsuperscript{16}

\begin{itemize}
  \item \textsuperscript{10} P. Hoffer & N. Hull, Impeachment in America, 1635-1805, at 85-86 (1984) (The work was a Pulitzer Prize nominee).
  \item \textsuperscript{13} A. Mason, Brandeis: A Free Man’s Life 23-24 (1946).
  \item \textsuperscript{14} Id. at 31.
  \item \textsuperscript{16} L. Baker, Brandeis and Frankfurter: A Dual Biography 91 (1984).
\end{itemize}
Brandeis’ view of the law as an arena for combatants is further seen in his explanation for having turned down an offer of a teaching position at Harvard Law School in order to remain in the private practice of law. “I really long for the excitement of the contest ...” he explained, “[t]here is a certain joy in the draining exhaustion and backache of a long trial, which shorter skirmishes cannot afford.”

The Constitution was drafted by worldly men who were wise in the nature of men and women. They, like Brandeis, understood the aggressive inclinations of human beings; they may have even felt themselves susceptible. Accordingly, they provided for checks and balances to prevent too much power from falling into the hands of a single branch of government; they provided for limited terms of office for Representatives, Senators, and the President; and, they provided for impeachment to cover the eventuality that the constitutionally mandated selection processes for leaders fell short. Only judges were protected with life tenure in office in order to ensure their judicial independence.

If men were angels, such provisions would be surplusage. But in their plan for self-government, the keen insight of the founding fathers into humanity’s aggressive nature has proven vital to the existence of our government for over 200 years.

MILITARY KING OR COMMANDER IN CHIEF?

Section II, Article II of the Constitution provides that “[t]he President shall be Commander-in-Chief of the Army and Navy of the United States, and of the militia of the several States, when called into the actual service of the United States ....” However, in keeping with the framer’s recognition of the need for checks and balances, Section VIII (11) of the Constitution grants Congress the power to declare war, not the President. Moreover, Section VII gives Congress, not the President, the

19. Id. at art. I, § 3, cl. 1.
20. Id. at art. II, § 1, cl. 1.
21. Id. at art. II, § 4.
22. Id. at art. III, § 1.
power to originate bills to raise revenue. This places the funds necessary for the support of the armed forces within Congressional control.

Even though the presidential term was limited to four years of elective service, and even though the President was made subject to impeachment by Article II, Section I and Article I (6), respectively, there was nevertheless strong antifederalist opposition to the ratification of the Constitution because of certain of its military provisions.

One of the objections voiced by the antifederalists was to the range of power vested in the President. Particularly objectionable to them was the provision that made the President the Commander-in-Chief. For example, some months before ratification of the Constitution, an antifederalist using the nom de plume "Philadelphiensis," but believed to have been Benjamin Workman, warned Americans that the proposed Constitution would declare "marital law ... to be the supreme law of the land," and that the "character of free citizens [would] be changed to that of the subjects of a military king..." He made additional references to "this tyrant" and declared that "[t]he President- general, who is to be our king after this government is established, is vested with powers exceeding those of the most despotic monarch we know of in modern times."

Other anti-federalist papers voiced strong opposition to defense powers and national control of the militia, as well as to the proposed formation of a standing army.

The Federalist, authored by Hamilton, Madison, and Jay, supported the proposed constitution's designation of the President as Commander-in-Chief. Hamilton emphasized that war requires a greater concentration of power in the hands of a chief executive than is necessary in a time of peace.

The propriety of this provision is so evident in itself, and it is, at the same time, so consonant to the precedents of the State constitutions in general, that little need be said to explain or enforce it. Even those of them which have, in other respects, coupled the chief magistrate with a council, have for the most part concentrated the military authority in him alone. Of all the

23. THE ANTIFEDERALIST PAPERS 212 (M. Borden ed. 1965).
24. Id. at 213 (emphasis added).
25. Id. at 57, 62, 66.
cares or concerns of government, the direction of war most peculiarly demands those qualities which distinguish the exercise of power by a single hand. The direction of war implies the direction of the common strength; and the power directing and employing the common strength, forms a usual and essential part of the definition of the executive authority.  

Hamilton's comments reveal the rationale that lies behind the concepts of command responsibility and unity of command. It is the executive who is perceived to have command - not the legislature or courts. It is, accordingly, the executive who must have expanded powers in wartime.

Justice Story later commented on the uniqueness of the power of the Commander-in-Chief. In a decision of the Supreme Court issued before the death of Chief Justice John Marshall, Story discussed the power of the President to call out the militia during the War of 1812.

It is, in its terms, a limited power, confined to cases of actual invasion, or of imminent danger of invasion. If it be a limited power, the question arises, by whom is the exigency to be judged of and decided? Is the President the sole and exclusive judge [as to] whether the exigency has arisen, or is it to be considered as an open question, upon which every officer to whom the orders of the President are addressed may decide for himself. 

In Korematsu v. United States, a notorious case involving an executive order directing the confinement of Americans of Japanese extraction at the outset of World War II, Justice Jackson observed in dissent:

The armed services must protect a society, not merely its Constitution. The very essence of the military job is to marshal physical force, to remove every obstacle to its effectiveness, to give it every strategic advantage. Defense measures will not, and often should not, be held within the limits that bind civil authority in peace. No court can require such a commander in such circumstances to act as a reasonable man; he may be

unreasonable, cautious and exacting. Perhaps he should be.\textsuperscript{29}

This view of command emphasizes the singular nature of the responsibility of the commander. Indeed, the power of the Commander-in-Chief was once regarded to be so great in war time as to encompass his authority to abolish slavery - such authority being based on the executive's duty to defend the nation.\textsuperscript{30}

Nevertheless, the Constitution itself remains in effect during time of war. In the important \textit{Milligan} case, the Supreme Court, through Justice David Davis, wrote that:

\begin{quote}
The Constitution of the United States is a law for rulers and people, equally in war and in peace, and covers with the shield of its protection all classes of men, at all times, and under all circumstances. No doctrine, involving more pernicious consequences, was ever invented by the wit of man than that any of its provisions can be suspended during any of the great exigencies of government.\textsuperscript{31}
\end{quote}

The Court concluded that the defendant, a civilian, could not be tried by a military tribunal for aiding the enemy because the location of the trial was in a non-combat area where the civilian courts should have been resorted to.\textsuperscript{32}

When James Wilson proposed at the constitutional convention that a single executive for the federal government be provided for, rather than a committee or council, it is reported that "a sudden silence followed" among the delegates.\textsuperscript{33} Concern was expressed that a plural executive was needed to insure against "the fetus of monarchy."\textsuperscript{34} But the concept of a single executive prevailed not only at the national level but in all of the fifty states. Limits on the executive term of office were provided to allay fears of the re-institution of a monarchy. Today, if the apprehension were to be expressed that a monarchy might be imposed on Americans, it would not be taken seriously; the single executive is now, happily, an unquestioned institution.

\textsuperscript{29} Id. at 244 (Jackson, J., dissenting) (emphasis added).
\textsuperscript{30} W. WHITING, WAR POWERS UNDER THE CONSTITUTION OF THE UNITED STATES 20, 82 (1871).
\textsuperscript{31} Ex parte Milligan, 71 U.S. (4 Wall.) 2, 120-21 (1866).
\textsuperscript{32} Id. at 126-30.
\textsuperscript{33} C. BOWEN, supra note 2, at 55.
\textsuperscript{34} Id. at 57.
In the words of a popular poster, “God so loved the world that he did not send a committee.”

The American system of government, by its nature, demands a civilian Commander-in-Chief. “While the President customarily delegates supreme command of ... [military] forces in active service, there is no constitutional reason why he should do so; and ... [presidents have] been known to resolve personally important questions of military policy.” 35 Professor Corwin cites a number of instances where Presidents personally made important military decisions in their capacity as Commander-in-Chief. He names Lincoln and Wilson as examples, and observes that President Truman himself ordered that atomic bombs be dropped on Hiroshima and Nagasaki in 1945.36

The Commander-in-Chief is, therefore, a powerful military leader, one whose power, however, is tempered to an important degree by the Congressional power of control over the national purse. In addition, the actions of the Commander-in-Chief are increasingly subject to the scrutiny and quasi-control of public opinion. In this latter respect, however, the personality of the President can be important. When Theodore Roosevelt sent the Atlantic fleet on a mission to the Pacific, there ensued an outcry on the east coast that the area was being left without a defense. Congress, prompted by these complaints, threatened to cut off the funds supporting the Pacific mission. Roosevelt retorted that while Congress could cut off his mission funds, he still had sufficient money to get the fleet to the Pacific Ocean. If Congress had carried through on its threat, Roosevelt's response would have been to simply leave the fleet in the Pacific! 37 But Teddy Roosevelt lived in less complex times than we do today. Communications were slower and the immediate threat of “the bomb” did not exist.

Faithful to its concern for checks and balances, the Constitution did not place the entire war making power in either the President or the Congress. However, since the war powers seem to inherently require their exercise by a single individual rather than by a committee or council, both the Constitution

36. Id. at 101-02.
and the case law interpreting it tend to emphasize the executive's role over that of the legislature.

Professor Garry Wills has suggested recently that the atomic bomb has enhanced the power of the President as Commander-in-Chief beyond the level envisioned in the originally conceived system of checks and balances. This, according to Wills, results from the quasi-war status that has existed since World War II. He contends that this status has also permitted the CIA to exist as an "unconstitutional body." 38 However, we have seen through the words of Justice Story and Justice Jackson that the President's role as Commander-in-Chief has been accorded special deference since well before World War II. Even so, Wills pointedly contrasts the degree of Presidential accountability that he presumes was expected by the framers of the Constitution with the governmental secrecy he sees as increasingly prevalent in modern times.

Despite the fears of the founding fathers, the tremendous military power in the hands of our chief executive has not, however, resulted in the rebirth of monarchy.

Living in the shadow of the Revolution, remembering the declamations against the army of England, and fearful that a standing army might be employed by an American Caesar as an instrument for overthrowing the republic and establishing a dictatorship, the men of that age were, as a result of recent experience and the reading of Roman history, susceptible to this argument to a degree we find it difficult to understand. Their fears have never been even remotely justified by what has happened in the United States. From Washington to Eisenhower we have elected four national heroes (Jackson and Grant are surely of that rank) and several lesser figures with military reputations. None has attempted, or would have countenanced, anything resembling a coup d'etat, [or any] attempt to set aside the processes of constitutional government and establish a dictatorship. 39

MILITARY PREPAREDNESS

In The Federalist, Number 24, Hamilton wrote of the need for military preparedness from what might today be described as a geopolitical point of view.

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Though a wide ocean separates the United States from Europe, yet there are various considerations that warn us against an excess of confidence or security. On one side of us, and stretching far into our rear, are growing settlements subject to the dominion of Britain. On the other side, and extending to meet the British settlements, are colonies and establishments subject to the dominion of Spain. This situation and the vicinity of the West India Islands, belonging to these two powers, create between them, in respect to American possessions and in relation to us, a common interest. The savage tribes on our Western frontier ought to be regarded as our natural enemies, their natural allies, because they have most to fear from us, and most to hope from them. The improvements in the art of navigation have, as to the facility of communication, rendered distant nations, in a great measure, neighbors.\footnote{Id. No. 24, at 206-07 (A. Hamilton).}

In response to the urgings of Hamilton and the other Federalists, therefore, the Constitution contains a number of very specific provisions relating to defense. These include the power to raise and support an Army and Navy,\footnote{U.S. Const. art. I, § 8, cl. 12 & 13.} to call out the state militia,\footnote{Id. at art. I, § 8, cl. 15.} to erect forts, magazines, arsenals and dockyards,\footnote{Id. at art. I, § 8, cl. 17.} and the right to bear arms.\footnote{Id. at amend. II.} The Constitution, however, also contains provisions relating to the military in broader terms. These provisions address requirements for internal order and the supremacy of the central government in dealing with external threats. They prohibit states from maintaining troops in peacetime and from engaging in war without the consent of Congress.\footnote{Id. at art. I, § 10, cl. 3.} The Bill of Rights provision prohibiting the quartering of soldiers in households without the consent of the owner\footnote{Id. at amend. III.} addresses neither of these concerns, but merely reflects the public outrage against this British practice during the Revolutionary war. It would be interesting to speculate on the fate of this provision if a war were to be once again fought on American soil, and it was American soldiers requiring the quartering.
There have been a number of proposals to amend the military provisions of the Constitution. One such proposed amendment, made, perhaps prophetically, prior to the war in Vietnam, was that "[n]o citizen of the United States shall be compelled to serve in the Armed Forces of the United States in any foreign country unless Congress has declared war on that country."\textsuperscript{47}

In 1957, Jefferson B. Fordham, the Dean of the University of Pennsylvania Law School at the time, pointed out the absurdity of such a proposal. "Under such a dispensation, our military personnel could not even be compelled to serve in the territory of an ally in preparing for or staging an attack on an enemy against whom Congress had declared war."\textsuperscript{48}

Although the need for a strong defense is almost universally understood and accepted, it is important to remain alert to any unwarranted erosion of constitutionally mandated defense authority. Pressures to erode it have existed, in one form or another, since before the Constitutional Convention and they are not going to disappear in the future.

**Conclusion**

The Constitution of the United States is not perfection. The people have found occasion before now to amend it and there will be further occasions in the years ahead. There can be no question, however, but that it was so sound in basic conception that it has stood the test of nearly 175 years of experience, years marked by the most remarkable economic and social changes the world has known. It was conceived as a relatively simple and brief organic political instrument—a charter of government. Taken with the almost contemporaneous Bill of Rights and certain later amendments, it is pretty well confined to the four essentials of a constitution which I have outlined. Viewed in its total content, it is written in the large with a minimum of ephemeral specificity and of meanness of detail. This is the durable central characteristic of the Constitution.\textsuperscript{49}


\textsuperscript{48} J. Fordham, supra note 47, at 16.

\textsuperscript{49} Id. at 10 (emphasis added). The four elements to which Dean Fordham referred are: "1. Provision of the basic framework of government; 2. [Broad distribution] of governmental powers within the designed framework, with secondary power-devolution left to the legislative arm; 3. Substantive and procedural guarantees to the individual against the arbitrary exercise of governmental authority—a bill of rights; and 4. Provision of machinery for change in the Constitution." Id. at 9-10.
As we proceed through this five year period of celebration of our nation's charter, therefore, we should make every effort to understand the fundamentals that have enabled the Constitution to maintain us as a strong and independent free nation. Neglect of our Constitution's military provisions might constitute the greatest threat to both our survival and the continuation of our heritage of freedom.\(^50\)

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COMMENTS

REDA PUMP, A DIVISION OF TRW, INC. V. FINCK: AN UPDATE ON KENTUCKY PRODUCT LIABILITY LAW

In Reda Pump, A Division of TRW, Inc. v. Finck, the Supreme Court of Kentucky held, pursuant to the Kentucky Product Liability Act, that contributory negligence is a complete bar to recovery in a product liability case.

The broad language of the statute, coupled with certain language in the opinion, presents a number of issues which must be addressed: first, how the comparative fault doctrine in Kentucky will be affected; second, whether Kentucky is moving away from a strict liability standard in product liability cases; third, how the apparent conflict between the Product Liability Act and the warranty provisions of the Uniform Commercial Code will be resolved; and finally, how the court will reconcile seemingly conflicting cases applying the special legislation provisions of the Kentucky Constitution.

I. BACKGROUND

A. Product Liability Cases

In 1916 the New York Court of Appeals decided, in MacPherson v. Buick Motor Company, that liability for negligent manufacture could be claimed by a plaintiff who had not bought the product directly from the defendant. In the 1960 case of Henningsen v. Bloomfield Motors, Inc., New Jersey extended the principle of

1. Reda Pump, A Division of TRW, Inc. v. Finck, 713 S.W.2d 818 (Ky. 1986).
3. 713 S.W.2d at 820.
6. KY. CONST. § 59.
liability without privity of contract to cases arising under the warranty provisions of the Uniform Sales Act.

In 1944, Justice Traynor of the California Supreme Court set forth the policy underlying strict product liability in his often quoted concurrence in *Escola v. Coca Cola Bottling Co. of Fresno*. His opinion pointed out that a manufacturer can anticipate some product hazards and prevent the recurrence of others. The manufacturer can insure against the loss, and spread the premium costs among the large number of consumers. Justice Traynor further observed that it is in the public interest for the law to provide an economic incentive for making products as safe as possible. The manufacturer, by choosing to market a product, voluntarily assumes the responsibility to make sure it is reasonably safe for its intended use. The manufacturer is in the best position to discover where in the manufacturing process the defect was introduced.10

Nineteen years later, with Justice Traynor speaking for the majority, California adopted a strict product liability standard in *Greenman v. Yuba Power Products Co.*. In 1965 the American Law Institute adopted the language in Section 402A of the Restatement of Torts, expressing the view that those in the business of making or selling a product may be liable to the ultimate user or consumer without a showing of negligence and without privity of contract.12

In 1966, Kentucky adopted virtually all of these developments in *Dealers Transport Co. v. Battery Distributing Co.*. Although the court indicated that it would not require privity of contract to find liability in a cause of action based on breach of implied warranty,14 the holding specifically adopted Section 402A of the Restatement of Torts as the standard for product liability.15 Among the things Section 402A purports to do is to abolish contributory negligence as a defense in product liability cases.

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10. Id. at 462, 150 P.2d at 441.
12. *Restatement (Second) of Torts* § 402A (1965) [hereinafter Restatement § 402A].
14. Id. at 446.
15. Id. at 446-47.
unless such negligence amounts to knowing, voluntary, and un-
reasonable assumption of risk. 16

In the 1968 Kentucky case of Post v. American Cleaning Equip-
ment Corp. 17 the court, while acknowledging the strict liability
standard in product cases, nevertheless applied a negligence
standard for failure to warn and allowed the defense of contrib-
utory negligence to serve as a complete bar to recovery. While
the choice of words used by the court is perhaps unfortunate,
the result is within the Restatement view that a seller who gives
an adequate warning is entitled to assume it will be read and
heeded; therefore, a product with such a warning is neither
defective nor unreasonably dangerous. 18 The labeling of this ra-
tonale as a form of contributory negligence is problematic be-
cause it implies that the manufacturer can escape liability if the
user was negligent in any way, even if the warning given by the
manufacturer was not sufficient to meet the standard imposed
by law. This defeats the initial purpose of promoting product
safety by forcing the manufacturer to give adequate warnings.

Product liability cases divide into design defect cases and
manufacturing defect cases. The former class includes cases
where the defect is in the design of the product so that even products
which conform perfectly to their designs are defective. The latter
refers to those cases where the defect consists of the failure of
a particular specimen to conform to its design. 19 Many courts
have applied a strict liability standard to manufacturing defects,
including defects in assembly, processing, and packaging. 20 Design
defect cases, on the other hand, have produced considerable
controversy. 21 This is partially due to the fact that the widespread

16. Restatement § 402A, supra note 12, at comment n. See Parker v. Redden, 421 S.W.2d
586 (Ky. 1967) (abolishing assumption of the risk defense unless, under the circumstances,
it amounts to contributory negligence). See also Houchin v. Willow Avenue Realty Co.,
453 S.W.2d 560 (Ky. 1970).

17. Post v. American Cleaning Equipment Co., 437 S.W.2d 516, 521 (Ky. 1968).

18. Restatement § 402A, supra note 12, at comment j. See W. PROSSER & W. KEETON,
PROSSER AND KEETON ON THE LAW OF TORTS § 99(2) at 697 (W. Keeton 5th Ed. 1984)
[hereinafter PROSSER AND KEETON].

Rptr. 225 at 233 (Cal. 1978).

20. PROSSER AND KEETON, supra note 18, at 695-96.

the Products Liability System, 11 Hofstra L. Rev. 845 (1983); contra Twerski, From Risk-
Utility to Consumer Expectations: Enhancing the Role of Judicial Screening in Product
distribution of nationally marketed products poses a threat of large-scale litigation and large damage awards to manufacturers.\textsuperscript{22}  

In the 1978 case of \textit{Barker v. Lull Manufacturing Co., Inc.},\textsuperscript{23} the California Supreme Court adopted a two prong test for design defect cases. According to this test, if a plaintiff succeeds in showing that a "product failed to perform as an ordinary consumer would [have expected]" while being "used in an intended or reasonably foreseeable manner", the product is defective in design and the demonstration of the existence of a \textit{particular} defect is not necessary. Failing this, if the plaintiff can show that, in hindsight, the design proximately caused his injury, then the burden shifts to the manufacturer to demonstrate that the utility of the particular design outweighs the risks inherent in it.\textsuperscript{24}  

In the 1975 case of \textit{Embs v. Pepsi-Cola Bottling Co. of Lexington},\textsuperscript{25} the Kentucky Court of Appeals applied the strict liability standard where a bottle of Pepsi-Cola exploded, causing the plaintiff's injuries, without requiring the plaintiff to show the exact nature of the defect or at what point in manufacturing, processing, or handling the defect occurred. The court recognized a presumption of defectiveness in cases where problems of proof are great and the accident is one that, in common experience, would not occur if the product were not defective. Additionally, the plaintiff was not required to show which of several defendants was responsible for the defect, but rather, was awarded a judgment against \textit{all} of the defendants, who then could resolve among themselves the question of who should pay.\textsuperscript{26}  

In 1976, the court held in \textit{Ulrich v. Kasco Abrasives Co.}\textsuperscript{27} that, in product cases, knowledge of the defect is imputed to the manufacturer and the test of unreasonable dangerousness is whether a prudent manufacturer, having such knowledge, would have marketed the product. However, the court added that, where the consumer fails to properly maintain the product, alters,
or misuses it, he cannot recover on a strict liability theory. Such consumer misuse can also constitute a superseding cause, relieving the manufacturer of liability.\textsuperscript{28}

In one design defect case, the court has backed away from the liberal approach of the California courts and applied a negligence standard. The Kentucky Court of Appeals held in the 1973 case of \textit{Jones v. Hutchinson Manufacturing, Inc.}\textsuperscript{29} that a manufacturer is not liable if he has used reasonable care in designing a product even though there may have been a safer design available and the plaintiff can show that, had such a design been used, his injury would not have occurred. This is in marked contrast to the California test requiring a manufacturer to use the safest design available unless it can be demonstrated that the benefits of the design used outweigh the risks attending that design.\textsuperscript{30} The California position rests upon policies of reducing danger to the public and placing loss upon those best able to bear it or insure against it.\textsuperscript{31}

The Kentucky Supreme Court held in the 1980 case of \textit{Nichols v. Union Underwear Co., Inc.}\textsuperscript{32} that the so-called “patent danger rule” was not a defense in product liability cases. The Court regarded user knowledge and obviousness of the danger merely as factors in the determination of whether a product is unreasonably dangerous to consumers. \textit{Nichols} also prescribed the jury instruction currently used in Kentucky, which restores the test of imputed knowledge to design defect cases.\textsuperscript{33}

You will find for the plaintiff only if you are satisfied from the evidence that the material of which the T-shirt was made created such a risk of its being accidentally set on fire by a child wearing it that an ordinarily prudent company engaged in the manufacture of clothing, being fully aware of the risk, would not have put it on the market; otherwise, you will find for the defendant.

In summary, the Kentucky cases on product liability utilize the standard of Section 402A of the Restatement of Torts.\textsuperscript{34} Kentucky

\textsuperscript{28} \textit{Id.} at 200.
\textsuperscript{29} Jones v. Hutchinson Mfg., Inc., 502 S.W.2d 66 (Ky. 1973).
\textsuperscript{30} \textit{Barker}, 20 Cal.3d at 431, 573 P.2d at 455, 143 Cal. Rptr. at 237.
\textsuperscript{31} Luque v. McLean, 8 Cal.3d 136 at 145, 501 P.2d 1163 at 1169, 104 Cal. Rptr. 443 at 449 (Cal. 1972).
\textsuperscript{32} Nichols v. Union Underwear Co., 602 S.W.2d 429 (Ky. 1980).
\textsuperscript{33} \textit{Id.} at 432-33.
\textsuperscript{34} \textit{Dealers Transport}, 40 2 S.W.2d at 446-47. \textit{See} Miller, \textit{The Kentucky Law of Products Liability in a Nutshell}, 12 N. KY. L. REV. 182 (1985).
rejects California's "consumer expectation test" and instead determines unreasonable product dangerousness on the basis of whether a prudent manufacturer would market the product if he knew of the defect (the Wade-Keeton imputed-knowledge standard). Both assumption of risk and consumer misuse are treated as forms of comparative fault. There is no defense based on the "patent danger rule." Lastly, a presumption of defectiveness is recognized where the accident is of a type that, in common experience, would not have occurred unless the product had been defective.

B. The Kentucky Product Liability Act

The provisions of the Act are quite brief and easy to understand. The thorny problems lie in trying to reconcile the Act with the common law, other statutes, and the Kentucky Constitution.

Section 411.300 states that the Act applies to "any action for or on account of personal injury, death or property damage caused by or resulting from the manufacture, construction, design, formulation, development of standards, preparation, processing, assembly testing, listing, certifying, warning, instructing, marketing, advertising, packaging or labelling of any product." This essentially codifies the Restatement position that the burden of proving defectiveness is on the plaintiff except that the statutory presumption does not apply to new products. It modifies the holding of Embs for products sold more than five, or manufactured more than eight, years prior to the accident or injury. Similarly, Section 411.310(2) allows the manufacturer to shift the burden of proof back to the plaintiff if he can show either

35. Nichols, 602 S.W.2d at 433; Ulrich, 532 S.W.2d at 200.
36. 421 S.W.2d 586 (Ky. 1967); Post, 437 S.W.2d at 521.
37. Nichols, 602 S.W.2d at 432.
38. Embs, 528 S.W.2d at 706.
40. Id. at § 411.310(1).
41. Restatement § 402A, supra note 12, at comment g.
42. Embs, 528 S.W.2d at 706.
that the product was made in compliance with industry standards or according to the state of the art.\textsuperscript{43}

While these rules impose obstacles to recovery, particularly in terms of discovery and proof, neither bars recovery nor affects the size of the plaintiff's award. Viewed objectively, these provisions can be seen as a legitimate attempt to limit liability to those cases where the defectiveness of the product is obvious or the plaintiff can demonstrate a particular defect.

Sections 411.320(1) and (2), applicable to cases of consumer misuse of products, codify the Ulrich doctrine that one who misuses, modifies, or fails to maintain a product can recover only to the extent that his misuse, modification, or failure to maintain did not cause the harm.\textsuperscript{44} This is in accord with the Restatement.\textsuperscript{45}

Kentucky Revised Statutes Annotated 411.320(3) states as follows:

In any product liability action, if the plaintiff failed to exercise ordinary care, in the circumstances, in his use of the product, and such failure was a substantial cause of the occurrence that caused the injury or damage to the plaintiff, the defendant shall not be liable whether or not said defendant was at fault or the product was defective (emphasis added).\textsuperscript{46}

It is significant that the language does not mention contributory negligence, but flatly states "the defendant shall not be liable." It is also noteworthy that the provision applies to any cause of action.\textsuperscript{47}

Section 411.330 makes the admissibility of evidence pertaining to defectiveness and consumer alterations subject to a preliminary ruling by the court.\textsuperscript{48} Section 411.340 exempts retailers and middlemen from liability where the manufacturer is primarily responsible and subject to jurisdiction, unless such retailers or middlemen alter the product or make express warranties.\textsuperscript{49}

\section*{C. Comparative Fault}

In 1975, California judicially adopted the "pure" comparative fault system in the much quoted case of \textit{Li v. Yellow Cab Co. of

\begin{thebibliography}{99}
\bibitem{43} Product Liability Act, \textit{supra} note 2, at § 411.310(2).
\bibitem{44} \textit{Id.} §§ 4 11.320(1), 411.320(2).
\bibitem{45} \textit{RESTATEMENT} § 402A, \textit{supra} note 12, at comment n.
\bibitem{46} Product Liability Act, \textit{supra} note 2, at § 411.320(3).
\bibitem{47} \textit{Id.} at § 411. 300.
\bibitem{48} \textit{Id.} at § 411.330.
\bibitem{49} \textit{Id.} at § 411.340.
\end{thebibliography}
California. The opinion strongly criticized the doctrine of contributory negligence for its harshness and all-or-nothing rigidity. In support of this view, Prosser points out that there is no cautionary benefit to be derived from contributory negligence since motorists are not likely to be contemplating the refinements of legal liability while driving. Prosser also notes that further confusion in the law is caused by makeshift doctrines, such as the "last clear chance" rule, introduced by courts out of frustration with the contributory negligence doctrine and lacking a coherent theoretical basis.

With the 1984 decision of Hilen v. Hayes, Kentucky became the forty-second state to adopt some form of comparative fault. In Hilen, Justice Liebson, speaking for the supreme court, noted that juries frequently indulged in a process of fault allocation in disregard of their instructions because the contributory negligence doctrine is simply contrary to reason and common sense. The opinion goes on to say that comparative fault is not a "no-fault" system since each party is liable for the "injury in direct proportion" to his fault. The opinion points out that the system is fair because no party is denied recovery to the extent that another is at fault, and no party has to pay a share greater than his proportion of fault. This is seen as preferable to the systems of "equal fault bar" and "greater fault bar" because there is a point in each of these approaches where recovery becomes an all-or-none decision.

The comparative fault system is clearly superior to the contributory negligence doctrine. However, the collision between

50. Li v. Yellow Cab Co. of California, 13 Cal.3d 804, 532 P.2d 1226, 119 Cal. Rptr. 858 (Cal. 1975).
51. Id. at 809; 532 P.2d at 1230, 119 Cal. Rptr. at 862.
52. PROSSER AND KEETON, supra note 18, at 469.
53. Id. at 468.
55. Id. at 718. See Li, 13 Cal.3d at 811-12, 532 P.2d at 1231, 119 Cal. Rptr. at 863.
56. 673 S.W.2d at 718.
57. Id.
58. Id. at 719. See Li, 13 Cal.3d at 827-29, 532 P.2d at 1242-43, 119 Cal. Rptr. at 874-75.
59. The Hilen Court states that "[a] list of the critics of contributory negligence as a complete bar to recovery reads like a tort hall of fame. The list includes, among others, Campbell, Fleming, Green, Harper and James, Dreton, LeFlar, Malone, Pound and Prosser." 673 S.W.2d at 717.
the holding in *Hilen* and the Product Liability Act was inevitable. Within months after the *Hilen* decision, Judge Bertlesman, in *Anderson v. Black & Decker, Inc.*, pointed out that the language of the statute was not capable of more than one interpretation.  

II. **REDA PUMP**

A. *The Facts of the Case*

James R. Finck sustained burns over forty percent of his body when a submersible pump manufactured by the Reda Pump Company exploded. In a cost-cutting move during the mid-1970’s, Reda had replaced several brass parts on its line of three-horsepower submersible pumps with substitutes made of lexan, a plastic material. The pump involved in this case was one of those with lexan parts.

Reda had advertised these pumps as usable in oil wells. It was well known in the industry when the pump was sold that lexan would deteriorate when exposed to certain hydrocarbons present in oil wells, but this information was not communicated to the public, nor to those whose job it was to repair such equipment.

Reda, *when asked*, would tell a customer to replace the lexan parts with brass ones before using the pump in an oil well, but maintained a policy of keeping this information closely guarded. The pump in question had been used in an oil well before being brought for repairs into the shop where Finck worked.

In order to take the pump apart for repairs, the repairman had to heat the screws that held it together in order to break an epoxy seal used to keep out moisture. The standard proce-

60. *Anderson v. Black & Decker, Inc.*, 597 F. Supp. 1298 (E.D. Ky. 1984). This decision by Judge Bertelsman held that the Kentucky Product Liability Act made contributory negligence a complete bar to recovery in such cases.


62. *Id.* at 4.

63. *Id.*

64. *Id.*

65. *Id.* at 4, 5.

66. *Id.* at 5.

67. *Id.*

68. *Id.* at 4.
dure was to drain oil out of the motor before doing this. Finck did not follow the procedure. The pump Finck was repairing had burned out in an oil well, causing a flammable gas to accumulate inside it.

Although Finck knew that it was standard procedure to drain the oil out of the motor before heating the epoxy seal, he did not know that a failure to do so would expose him to great danger, that the motor could explode, or that he could receive serious burns as a consequence. During the heating, the “oil bag cap,” a lexan part weakened by exposure to hydrocarbons in an oil well, gave way, allowing flammable substances inside the motor to come into contact with the flame and explode, causing his injuries. Finck knew that the oil would expand when heated and that it was flammable. An expert witness testified that the accident would not have happened if the oil bag cap had been made of brass.

The jury found both Reda and Finck to have been negligent and apportioned responsibility thirty-four and one-quarter percent to Finck and sixty-five and three-quarters percent to Reda.

B. The Opinion of the Court

Reda Pump presented the Kentucky Supreme Court with two main questions. First, does the Kentucky Product Liability Act make a plaintiff’s negligence a complete bar to recovery? Second, if so, is the Act constitutional? The Court answered both questions affirmatively.

As discussed previously, the Act applies to any cause of action concerning product failure regardless of whether it sounds in contract, negligence, or strict liability. It is the allegation that

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69. Id. at 5.
70. Id. at 6.
71. Id. at 5.
72. Id. at 405
73. Id. at 6.
74. Brief for Appellant at 6, Reda Pump, A Div. of TRW, Inc. v. Finck, 713 S.W.2d 818 (Ky. 1986).
75. Brief for Appellee at 6, Reda Pump, A Div. of TRW, Inc. v. Finck, 713 S.W.2d 818 (Ky. 1986).
76. 713 S.W.2d at 819.
77. Id.
78. Id. at 820-21.
79. Product Liability Act, supra note 2 at § 411.300; see supra note 48.
the injury was caused by a product-related defect, not a theory of recovery, that triggers the operation of the statute.

The statute does not specifically mention the contributory negligence defense, but rather says that the plaintiff shall not recover if he was negligent and such negligence was a substantial cause of the occurrence which caused his injury. The supreme court, applying Bailey v. Reeves and Gateway Construction Co. v. Wallbaum, found that these words were not susceptible of any other construction according to the “plain meaning rule.”

The majority concurred with Judge Bertelsman’s opinion in Anderson that the statute had been enacted to limit liability, and not, as the dissent suggested, merely to codify existing laws. The court further determined that the Act does not conflict with Section 59(5) of the Kentucky Constitution, which forbids local and special legislation. Commenting that the making of policy is a legislative and not a judicial function, the court described the holding of Hilen as “judicial fiat.”

The plaintiff argued that an interpretation of the Act to make contributory negligence a complete bar to recovery in products cases would create different standards of liability for products and services, contrary to the constitutional standard announced in Tabler v. Wallace. The court responded that, since the Act was within the policymaking power of the General Assembly, to hold it unconstitutional because it conflicted with judge-made law would amount to “the ultimate arrogation of power unto ourselves,” and that any conflict or confusion in the law had been created by the judicial system.

C. The Dissent

Justice Liebson, author of the decision in Hilen v. Hayes, was the lone dissenter in Reda Pump. He opined that the plain

80. 713 S.W.2d at 820; see supra note 47.
81. Id. at 820, citing Bailey v. Reeves, 662 S.W.2d 832 (Ky. 1984).
82. 713 S.W.2d at 820, citing Gateway Const. Co. v. Wallbaum, 356 S.W.2d 247 (Ky. 1962).
83. Id. at 819.
84. Id. at 820, citing Anderson, 597 F. Supp. at 1300.
85. 713 S.W.2d at 821.
86. Id.
87. Id. at 820; Tabler v. Wallace, 704 S.W.2d 179 (Ky. 1986).
88. 713 S.W.2d at 821.
89. Id. at 821 (Liebson, J., dissenting).
meaning doctrine of Bailey was inapposite because it leads to an absurd or wholly unreasonable result.\(^\text{90}\) In his view, this is because the majority’s holding “creates a special status for contributory negligence in product liability actions.”\(^\text{91}\)

Citing Tabler, Justice Liebson opined that it is unconstitutional to create an arbitrary distinction between goods and services, “not based on a natural, real, or substantial distinction inherent in the subject matter.”\(^\text{92}\) Therefore, the Product Liability Act, as interpreted by the supreme court, would be unconstitutional.

There are really two parts to Justice Liebson’s constitutional analysis. The second part is based on the 1957 case of Louisville & Nashville R.R. Co. v. Faulkner,\(^\text{93}\) in which the court held that, even though constitutional when passed, a statute can become unconstitutional where an impermissible distinction is created by changed circumstances. Therefore, Justice Liebson reasoned, even though the Product Liability Act was constitutional when passed, it became unconstitutional, due to the decision in Hilen, if construed to be a complete bar to recovery where the plaintiff is negligent.\(^\text{94}\) Faced with two possible interpretations, one constitutional and the other not, a court should so construe the law as to make it conform to constitutional requirements.\(^\text{95}\) Under this reasoning, the Product Liability Act should be interpreted to apply the comparative fault system of Hilen in the event of a plaintiff’s negligence rather than establish a complete bar to recovery.

The dissent argued that the purpose of Section 41 1.320(3) of the Act was merely to resolve the question of whether a plaintiff’s negligence could furnish any defense, and not to determine the effect of the defense, let alone create a bar to recovery.\(^\text{96}\) Justice Liebson pointed out that the Product Liability Act was written in an era of consumer protection and argued that the statute was intended to codify the common law, not to limit manufacturers’ liability.\(^\text{97}\)

\(^{90}\) Id. at 822.

\(^{91}\) Id. at 823.

\(^{92}\) Id. at 823, quoting City of Louisville v. Klusmeyer, 324 S.W.2d 831, 834 (Ky. 1959).

\(^{93}\) Id. at 823, citing Louisville & Nashville R.R. Co. v. Faulkner, 307 S.W. 2d 196 (Ky. 1957).

\(^{94}\) 713 S.W. 2d at 823-24 (Liebson, J., dissenting).

\(^{95}\) Id. at 824, citing In re Beverly Hills Fire Litigation, 672 S.W.2d 922, 926 (Ky. 1984).

\(^{96}\) 713 S.W.2d at 822 (Liebson, J., dissenting).

\(^{97}\) Id.
Justice Liebson used three examples to demonstrate what he considered to be the unworkability of the dual standard created by the majority opinion. His first example is of a youth who dives into the shallow end of a motel swimming pool at night, causing injuries, and alleges that the pool was improperly designed and that the motel owner was negligent. In this situation, it is unclear whether the Act bars an action against the manufacturer of the pool, the owner of the motel, or both.98 Second, in the case of a motor vehicle accident where the defendant answers that the plaintiff was contributorily negligent and files a third party complaint against his own car's manufacturer, the manufacturer could escape liability entirely.99 His third example describes an action involving hospital malpractice, medical malpractice, and a defective prosthesis. In such a case, with its multiple parties, cross-claim, and varying theories of recovery, it would not be possible to coherently instruct the jury.100

To summarize, Justice Liebson's main points were that the Act can and should be seen as having created a comparative fault defense of plaintiff negligence; that to interpret it as insisting upon a complete bar based on the plaintiff's negligence creates an unconstitutional double standard; and that besides being unconstitutional, the standard is difficult or impossible to apply consistently and fairly.

III. Analysis

A. The Future of Comparative Fault in Kentucky

The comparative fault system adopted in Hilen, because of its flexibility, tends to be the fairest and most practical way of handling those cases where the plaintiff's negligence has contributed to his injury.101 Over many years the common law evolved from the rigid, all-or-none rules of trespass and case through negligence, contributory negligence and last clear chance, to a system adaptable to a jury's true assessment of fault.102 Fair,

98. Id. at 824.
99. Id.
100. Id.
101. See supra text and accompanying notes 51-63.
102. See 673 S.W.2d at 714-15.
practical, and workable law does not occur overnight, and when the arduous process of trial and error manages to arrive at such a solution, it would seem foolish to abandon it. Yet, by referring to the holding of Hilen as "judicial fiat" and blaming the current double standard on that decision, the supreme court seems to intimate that it is prepared to do just that.\textsuperscript{103}

A defense attorney for a seller of services might well argue that, if \textit{Tabler} stands for the proposition that different standards of liability for purveyors of goods and of services are constitutionally impermissible, the holding of Hilen may not be applied to a seller of services if it cannot be applied to a seller of goods.\textsuperscript{104}

This argument should be rejected for two reasons. First, \textit{Tabler} simply does not stand for such a broad proposition. The warranty provisions of the Uniform Commercial Code, Section 402A of the Restatement of Torts, and undoubtedly numerous other provisions of law, all call for standards of liability for goods that are different from those applied to services. Rather, as the opinion points out, \textit{Tabler} emphasizes arbitrary distinctions created to favor special interests.\textsuperscript{105} The second reason is obvious if one considers the case of a collision between a car and a taxicab where both drivers are equally at fault. It would be patently unfair to allow the driver of the taxicab to recover from the driver of the private car while holding that a passenger in the taxi can be barred from any recovery against the driver of the taxicab by being contributorily negligent.

Yet, similar inequity can be expected under current Kentucky law in a case where a plaintiff and a defendant surgeon are each somewhat negligent, but the failure of a prosthesis is a substantial cause of the plaintiff's injury. The plaintiff would not want to emphasize the role of the prosthesis since his claim against the manufacturer may be barred; however, the doctor cannot maintain a third party action against the manufacturer because of his own negligence. Therefore, either the doctor must pay more than his share of fault for the injury, or the plaintiff loses an unfair portion of his recovery.\textsuperscript{106}

\textsuperscript{103} 713 S.W.2d at 821.
\textsuperscript{104} \textit{Tabler}, 704 S.W.2d at 186.
\textsuperscript{105} \textit{Id.} at 183-86.
\textsuperscript{106} See \textit{Reda Pump}, 713 S.W.2d at 824. There are many possible variations of the examples in Justice Liebson's dissent and many others which may occur to the reader. There is no need to try to exhaust the possibilities. The examples are given purely for purposes of illustration.
Another old problem that can be expected to reappear is that juries, forced to make all-or-nothing decisions, will find some plaintiffs not to be at fault in situations where, under the Hilen rule of comparative fault, the same juries would have assigned partial responsibility to the plaintiffs because they consider a total bar to recovery, under the facts, to be unfair.107

The problems associated with contributory negligence are well documented.108 The manifest injustices that must inevitably stem from the present double standard suggest a voyage into uncharted waters whose perils can only be guessed.

B. Kentucky’s Modification of the Strict Product Liability Standard

Section 402A of the Restatement was adopted as the standard of liability for manufacturers and sellers of products in Kentucky more than twenty years ago.109 Since that time it has been modified considerably.

The Product Liability Act, for example, has modified 402A in three respects. First, the Act establishes a presumption of no defect where the product was made or sold more than eight or five years, respectively, prior to the injury.110 Secondly, it provides that a seller, other than the manufacturer, may not be sued where the manufacturer is available unless the seller modified the product or made an express warranty.111 Finally, it provides that a plaintiff who modifies or misuses a product is barred from recovery to the extent that his injury resulted from such misuse.112

The courts have also limited and modified the 402A standard. The imputed knowledge test in design defect cases still requires the plaintiff to demonstrate a particular defect.113 Most manufacturers are able to easily compile extensive documentation of their compliance with either industry standards or the state of the art.
while plaintiffs are at a great disadvantage in discovering the exact nature of a particular design defect.\textsuperscript{114}

This operates in conjunction with the presumption in the Product Liability Act that a product is not defective if it was manufactured in conformity with either the standard of the industry or with the state of the art.\textsuperscript{115} This, seemingly, weakens the holding of \textit{Embs} that a jury may presume that a product is defective where the incident is such that, in the light of common experience, it would not have otherwise occurred.\textsuperscript{116}

Contributory negligence in product liability cases must, therefore, be seen as part of an overall system of restrictions and limits on liability for manufacturers. In the twenty years since the adoption of the Section 402A standard, Kentucky has so modified that standard that it can now be said that the system favors the defendant. Given the economic and legal resources already at the disposal of manufacturers and insurance companies, successful product suits can be expected to be fewer in number in the near future than at any time since the adoption of Section 402A. It should be pointed out, however, that the restrictions are tailored to specific situations and the 402A standard remains unchanged where they do not apply.

C. Application to the
Implied Warranty Provisions of the Uniform Commercial Code

On its face, the Product Liability Act applies to any action for injury or property loss related to the manufacture of any product, thus necessarily including actions sounding in contract and based on the implied warranty provisions of the Uniform Commercial Code (U.C.C.) as adopted in Kentucky.\textsuperscript{117}

The implied warranty provisions of the U.C.C. include the implied warranty of merchantability and a specific warranty of fitness for a particular purpose when the seller knows how the product is to be used at the time he sells the goods.\textsuperscript{118} The former applies only to merchants, including manufacturers.\textsuperscript{119} The benefit

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{114.} \textit{Escola}, 24 Cal.2d 453 at 467, 150 P.2d at 441 (Traynor, J., concurring).
\item \textsuperscript{115.} \textit{Product Liability Act}, supra note 2 at § 411.310(2).
\item \textsuperscript{116.} \textit{Embs}, 528 S.W.2d at 706; see note 24 and accompanying text.
\item \textsuperscript{117.} \textit{KY REV. STAT. ANN. §§ 355.2-314, 2-315 (Baldwin 1986), UNIFORM COMMERCIAL CODE §§ 2-314, 2-315 (1978)}.
\item \textsuperscript{118.} \textit{Id}.
\item \textsuperscript{119.} \textit{Id. at § 355.2-314, § 2-314}.
\end{enumerate}
\end{footnotesize}
of both warranties has been extended in case law to run from
the manufacturer to the ultimate buyer, and Kentucky extends
the implied warranty of merchantability to family members and
those of the buyer's household who will foreseeably use the
product. The U.C.C. provides for exclusion or modification of
warranties as long as there is no unfair surprise. Remedies are
limited to direct and consequential damages, including personal
injury and property damage. However, the warranty extended
by Kentucky law to family members and those of the buyer's
household who are foreseeable users cannot be excluded.

Even given this exception, it is clear that a seller can limit his
liability through his power to contract so long as there is no
unfair surprise. The parties may, if they so desire, avoid con-
sequential damages, exclude damages resulting from improper
use, or any of a number of other possibilities. Therefore, no need
exists for a statute to protect sellers further from liability based
on contract. Implied warranties are widely relied upon; to deprive
the buyer of this protection amounts to a step backward toward
the era of caveat emptor.

There is no doubt that, read literally and given the plain
meaning of the words, as done in Reda Pump, the Product
Liability Act applies to actions sounding in contract. To this
extent, it should be modified by the General Assembly. The
doctrine of contributory negligence is redundant in contract cases
and introduces an element of unfair surprise with respect to
consumers who rely on the protection the law previously afforded
them.

D. Constitutionality

In Tabler v. Wallace the court, after a detailed discussion of
the legislative history of the Kentucky Constitution, concluded

120. Henningsen, 161 A.2d at 69.
121. KY REV. STAT. ANN. § 355.2-318 (Baldwin 1986); see U.C.C., supra note 8 at § 2-
318 (Kentucky has enacted alternative A).
122. Children and Vентers, Inc. v. Sowards, 460 S.W.2 d 343 (Ky. 1970); KY. REV. STAT.
ANN. at § 355.2-316 (Baldwin 1986).
124. KY. REV. STAT. ANN. at § 355.2-318 (Baldwin 1986).
125. Massey-Ferguson, Inc. v. Utley, 439 S.W.2d 57 (Ky. 1969).
127. Product Liability Act, supra note 1 at § 411.300.
that acts of the General Assembly may not constitutionally es-
395 tablish an unjustified classification limiting liability for a special
interest.129 This analysis pointed out that one of the driving forces
behind the adoption of the 1891 constitution was a desire to curb
the power and influence of special interests, specifically targeting
their ability to purchase protective legislation.130 Applying Sec-
59(5) of the Kentucky Constitution, the Tabler court struck
down a special statute of repose favoring architects and build-
ers.131

The court's holding focused on two things. First, the application
of Section 59 is more specific in its limitation of social and
economic legislation than that of the fourteenth amendment of
the United States Constitution.132 Second, an arbitrary distinc-
tion between the right to sue suppliers of goods and the right to sue
suppliers of services is impermissible.133

In this regard, both Judge Bertelsman, in Anderson, and the
Kentucky Supreme Court, in Reda Pump, found that the intent
of the General Assembly in enacting the Product Liability Act
was to limit liability for suppliers of goods.134 However, as pointed
out previously, unconstitutionality cannot depend on the creation
of a different standard alone, but must be determined according
to whether the distinction is arbitrary.135 This question was not
dealt with by the court. Rather, the opinion hinged upon the
legislative prerogative to set social policy.136

Analytically, the majority's argument on this point is a tauto-
logical nullity. If the legislature must always have the prerogative
to make differing standards, if its actions are always presumed
to be correct, and if any discrepancies created by those actions
are presumed to be inherent in the case law, not the legislative
action, then Section 59 is robbed of its meaning and purpose. For
Section 59 to be applied meaningfully, the court must inquire

129. Tabler, 704 S.W.2d at 186.
130. Id. at 183-84.
131. Id. at 183, 188.
132. Id.3 at 183.
133. Id. at 185-86. (The Court makes clear that the lack of a constitutionally acceptable
reason for the distinction was the true basis for its decision. This is the sine qua non of
special legislation.)
134. 713 S.W.2d at 820; 597 F. Supp. at 1300.
135. Tabler, 704 S.W.2d at 185-86; see note 137.
136. 713 S. W.2d at 820.
into the purposes of the legislation and the rationale stated or implied for a statute.

This does not mean that the Product Liability Act is necessarily arbitrary legislation. However, it does mean that the analysis of the Reda Pump majority was inadequate to demonstrate that the Act is not arbitrary. The majority opinion, while acknowledging the dual standard, does not advance any argument that the Product Liability Act is based upon a bona fide legislative purpose, or to establish that the dual standard is rationally related to that purpose. According to the Tabler decision, this element is, and must be, a crucial part of the constitutional analysis.\textsuperscript{137}

As pointed out in the dissent, it is not relevant that the double standard developed after the law was passed.\textsuperscript{138} This is true because the mere creation of a double standard is not the evil sought to be prevented by the constitution. What is sought to be avoided is the exertion of influence in the legislature, by whatever means, to gain economic advantage for a few at the expense of many.

In \textit{Kentucky Milk Marketing v. Kroger Co.},\textsuperscript{139} interpreting Section 2 of the Constitution, the Court said:

Section 2 is a curb on the legislature as well as on any other public body or public officer in the assertion or attempted exercise of political power... Whatever is contrary to democratic ideals, customs and maxims is arbitrary. Likewise, whatever is essentially unjust and unequal or exceeds the reasonable and legitimate interests of the people is arbitrary... No board or officer vested with governmental authority may exercise it arbitrarily. If the action taken rests upon reasons so insubstantial or the consequences are so unjust as to work a hardship, judicial power may be imposed to protect the rights of persons adversely affected.\textsuperscript{140}

This simple and eloquent statement embraces the spirit, not only of Section 2, but of Section 59 as well. However, the court gave Section 59 a rather narrow construction in Reda Pump, as opposed to the generous reading of Section 59 in Tabler and Section 2 in \textit{Kentucky Milk Marketing}. At some point one would hope for a full treatment of the constitutional issue in light of Section 2 of

\textsuperscript{137} See note 137 and accompanying text.
\textsuperscript{138} 713 S.W.2d at 823 (Liebson, J., dissenting).
\textsuperscript{139} Kentucky Milk Marketing v. Kroger Co., 69 1 S.W.2d 893 (Ky. 1985).
\textsuperscript{140} Id.
the Constitution, answering the question of whether the Product Liability Act was an arbitrary exercise of power as described in *Kentucky Milk Marketing* when it was enacted, or, in other words, whether the purpose of the law was to favor a special interest as was the Kentucky Milk Marketing Act.

IV. CONCLUSION

Legislative intent is an area of inquiry where little is ever settled in a very satisfactory way because for every legislator who intended a measure to accomplish one purpose, another can be found to have intended something else. Whatever the legislative intent, the Product Liability Act does limit liability in ways that the case law in Kentucky does not. If the General Assembly did not intend this result or does not find it desirable, they can only avoid it by changing the statute. In addition, many thorny judicial problems remain unsolved, not the least of which is the effect of the Act on actions arising under the U.C.C. warranty provisions.

The Kentucky Supreme Court did not analyze the constitutional issues raised by *Reda Pump* in a very satisfying way. The court appears to have ducked the issue of whether there exists a sufficient reason in the product liability area to create a higher standard of plaintiff conduct or lower standard of defendant conduct than that which prevails in other areas of litigation. This is especially curious since nearly all other jurisdictions have moved in exactly the opposite direction for the past twenty years.

The Kentucky Constitution was intended to protect people from the power of special interests to unfairly influence legislation. An important protection will be lost if the court fails to consistently invoke these watchguard provisions.

The court in *Reda Pump* answered one question but raised a variety of others, both for the Kentucky Supreme Court and for the General Assembly. Rather than laying to rest a troublesome issue, it opened a Pandora's Box of potential problems and controversies. One can only hope at this point that a new course can be steered that will achieve fairness to all parties and that big money interests will not succeed in depriving plaintiffs with legitimate grievances of their right to have their day in court.

JOE McGee
FEDERAL KEMPER INSURANCE COMPANY V. HORNBACK AND THE DEMISE OF FIRST PARTY BAD FAITH IN KENTUCKY

I. INTRODUCTION

Everyone has witnessed the bold insurance advertising which invades our homes through television, the mails, and telephone solicitation. These solicitations promise us a better night’s sleep because we won’t be caught unprotected; they’re the good hands people; they’re on our side; we can get a piece of the rock! Such slogans are made to inject, through human vulnerability, a peace of mind; a peace that, for many, is realized by satisfying their need to feel safe and secure. What many fail to realize, however, is that insurance is big business, as frugal with its money as we are with ours.

An insurance policy’s purpose is protection. The demand for this protection is what sells insurance. When an insured experiences a disaster, he expects his insurance company to fulfill its duty to protect him, usually in the form of money. But what happens to the insured when an insurance company refuses to pay the policy proceeds, thus failing in its duty? It seems clear that if the insurance company has a reasonable basis for nonpayment, its failure to fulfill its obligation may be tolerable to the insured, the courts, and society. On the other hand, if the insurance company fails to pay for frivolous reasons, thereby causing additional damage to the insured, what then? Can the insured sue for first party bad faith? Kentucky courts say no. In Federal Kemper Insurance Company v. Hornback\(^1\) the Kentucky Supreme Court held that an insurance company’s failure or refusal to pay according to the terms of its contract\(^2\) will give rise to a suit for breach of contract only.\(^3\) This decision overruled Feathers v. State Farm Fire & Casualty Company,\(^4\) which had taken the position that “the insurance company [is] akin to a fiduciary and if the company was not justified in its actions, then its conduct was tortious against the policyholder for which consequential and

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1. 711 S.W.2d 844 (Ky. 1986).
2. Id. at 845.
3. Id.
punitive damages may be presented to the factfinder."

In other words, the *Feathers* court had held that there was a cause of action in tort based on an insurance company's breach of covenant to pay a claim in good faith.

This note will examine the background of first party bad faith in insurance contracts, and its course in the Kentucky courts. The primary focus, however, will be on the *Hornback* decision and its implications, especially as to the adequacy of damages under its rule.

II. BACKGROUND

Traditionally, damages for breach of contract under an insurance policy were strictly limited to damages certain, those clearly related to the rights and duties embodied in the insurance contract, and foreseeable by the parties at the time the contract was made, i.e., within the contemplation of the parties as proximately following from the breach. Unfortunately for some insureds, this merely yielded the face value of the policy, plus interest, as compensation for the company's refusal to pay, even when the damages from the wrongful delay or denial exceeded the policy limits.

The earlier Kentucky cases viewed an insurance contract as a mere promise to pay money if an event described by the policy

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5. *Id.* at 696-97.
6. *Id.*
8. Hadley v. Baxendale, 9 Exch. 341, 156 Eng. Rep. 145 (1854). This case involved an agreement to ship a broken flour mill engine shaft to a town where it was to serve as a model for a new shaft. The delivery took seven days instead of the two anticipated by the parties. As a result, the flour mill was unnecessarily shut down five extra days. The proprietor of the mill brought suit for reimbursement from the carrier for profits lost during that time. Baron Alderson held that since no "special circumstances" had been communicated to the carrier, i.e., that profits would be lost if there was a delay in shipment (not foreseeable at the time the contract was made), lost profits would not be taken into consideration in estimating damages.
9. Clark v. Life Ins. Co., 245 Ky. 579, 53 S.W.2d 968 (1932). This case stated that: "[t]here are many classes of cases where consequential damages may be recovered for the violation of a contract, when such recovery may be considered as fairly within contemplation of the parties as proximately flowing from the breach. But we have been unable to find any case, nor have we been furnished one by counsel ..., where such damages may be recovered upon the breach of a promise sole to lend or pay money, except (emphasis added) to the extent of placing the complaining party in the exact position that he would have occupied had the contract not been breached." *Id.* at 969.
occurred.\textsuperscript{10} Therefore, only the principal sum, together with interest, was considered foreseeable in the event of a breach.\textsuperscript{11}

In \textit{Motors Insurance Corporation v. Jackson},\textsuperscript{12} the court considered a claim for consequential damages flowing from an insurance company's failure to pay on an automobile policy. This case was characterized as an "action on a contract sounding in tort."\textsuperscript{13} Jackson\textsuperscript{14} had bought a truck under a conditional sales contract (insurance included) which was later assigned by the seller to GMAC. The truck had been damaged in a collision one week after its delivery. The cost of repair was $387. The insurance company refused to cover the repair cost, alleging that Jackson had failed to pay the first installment (even though there was no evidence of this). The Jacksons were unable to pay the repair bill; and, as a consequence, the truck was repossessed and sold. The Jacksons pleaded that the company's wrongful failure to pay the repair bill had resulted in the loss of the truck and monetary loss to their business. The court held that the evidence of consequential damage was too indefinite.\textsuperscript{15}

At first blush, it appeared that the court was widening its view of insurance contract liability, and would have awarded consequential damages had they not been "too indefinite." A careful reading of the remainder of the opinion, however, reveals the contrary—"even had the evidence met the requirements of proof of such claimed consequential damages," said the court "there would have been no legal liability under the facts of this case.... The [lower] court should have directed a verdict for the [insured] plaintiff for the amount of [insurer's] liability under the policy...."\textsuperscript{16} Therefore, in 1960, Kentucky held to the "contract to pay money" theory, limiting recovery to the policy limits, plus interest, and excluding consequential damages.

\textsuperscript{10} McCarthy, \textit{PUNITIVE DAMAGES IN BAD FAITH CASES} § 1.4 (3d ed. 1983).
\textsuperscript{12} 340 S.W.2d 610 (Ky. 1960).
\textsuperscript{13} \textit{Id.} at 611.
\textsuperscript{14} \textit{Id.} Jackson was 87 years old, illiterate and infirm.
\textsuperscript{15} \textit{Id.} at 611-12.
\textsuperscript{16} \textit{Id.} at 612, citing Clark v. Life & Casualty Insurance Co., 245 Ky. 579, 53 S.W.2d 968 (1932).
In 1966, this traditional limitation upon recovery was reinforced in General Accident Fire & Life Assurance Corporation v. Judd.\textsuperscript{17} The Judd court refused to award consequential damages for the charges incurred from the storage and lost use of an insured's car after a collision. Moreover, the court held that punitive damages were also not recoverable, stating, "... punitive damages ordinarily [emphasis added] are not recoverable for a breach of contract."\textsuperscript{18} The court considered such damages to be too uncertain, speculative, and remote to be recovered in contract actions.\textsuperscript{19}

The court of appeals in Deaton v. Allstate,\textsuperscript{20} however, muddied the waters as to whether "consequential damages were recoverable in such actions." Although the court echoed Judd by characterizing this case (which addressed an allegation of bad faith in the handling of an insurance claim\textsuperscript{21}) as one solely based on breach of contract,\textsuperscript{22} and by holding that punitive and consequential damages were not recoverable, it left open the possibility of insurer liability based on its "unreasonable delay in settling [the] pending claim."\textsuperscript{23} Query: Deaton draws a fine line between damages suffered for "unreasonable delay" and "consequential damages." Can a court reasonably allow one and not the other?

The insureds in Feathers v. State Farm Fire & Casualty Company\textsuperscript{24} suffered a fire loss on May 31, 1981. They filed a proof of loss with State Farm which was rejected on the ground of misrepresentation. One year after the fire they still had not received any money from the insurance company. There had not even been active negotiations. They then filed suit to recover their losses, alleging that State Farm owed "a duty to act in good faith in effecting a fair and reasonable settlement of these just claims without harassment or unreasonable delay."\textsuperscript{25} Appel-

\textsuperscript{17} 400 S.W.2d 685 (Ky.1966).
\textsuperscript{18} Id. at 688; see also, Calamari & Perillo, Contracts § 14-3 (2d ed. 1977); Restatement of Contracts § 342 (1932).
\textsuperscript{19} McCarthy, supra note 10, at § 1.5.
\textsuperscript{20} 548 S.W.2d 162 (Ky. Ct. App. 1977).
\textsuperscript{21} Id. at 163.
\textsuperscript{22} Id. at 164.
\textsuperscript{23} Id. at 165.
\textsuperscript{24} Feathers, 667 S.W.2d 693 (Ky. Ct. App. 1983), discretionary review denied April 12, 1984.
\textsuperscript{25} Id. at 694.
lants further alleged mental suffering, anxiety, and loss of consortium as a consequence of the company’s action.

The issue for the court was whether the appellants had pleaded a cause of action for consequential and punitive damages. The court decided that this was a “pure first party contractual action alleging an independent tort arising from wrongful breach,” in other words, a tort action.

The court reasoned that if the allegations were true they showed a substantial wrong committed against a clearly protected interest and right. Citing a California case and a federal case, Gruenberg v. Aetna Insurance Company and Rogers v. Pennsylvania Life Insurance Company, the court held that an insurance company’s breach could be so great that it could constitute tortious conduct. The court’s holding, in an often quoted passage, states:

Once the policyholder has substantially complied with the terms and considerations required by the policy, and there is no substantial or credible evidence that the policyholder directly or indirectly set fire to his property for personal gain, then at that point, the insurance company becomes akin to a fiduciary as to the sums that may be owed under the policy.

Justification for withholding payment is a question for the fact finder, said the court. It side-stepped stare decisis by characterizing the company’s substantial breach as an independent tort rather than as an action in contract. It did, however, address cases that had relied on the breach of contract reasoning, and found them lacking. It was its opinion that “these and similar authorities [had been] flawed from the outset” because “they contained modifiers to the principle of law” they purported to support. For example, they expressed their holdings in such phrases as “damages ordinarily are not recoverable,” or “usually not allowed.” “These modifiers implicitly indicate,” said

26. Id. at 695.
27. Id.
28. Id. at 696.
32. Id.
33. Id.
34. The court considered Clark, Jackson, Judd, and Deaton in their overview.
the court, "that there are exceptions to the principle." In short, the court leapt over mountains climbed by other courts in arriving at a cause of action for first party bad faith, an independent tort based on a covenant of good faith and fair dealing. It also leapt from a philosophy which refused to award even consequential damages arising out of an insurer's failure to pay, to one allowing damages, consequential and punitive, for mental suffering, anxiety, and loss of consortium.

This "failure" on the part of an insurance company requires something more than mere negligence. The term "bad faith" implies some type of intentional wrongful conduct; mere errors in judgment should not be sufficient to establish it. "There must be some proof [the insurance company] acted intentionally, willingly or in reckless disregard of its insured's rights." Again, whether conduct is tortious is a jury question and the insured must have substantially complied with the terms of the policy as a condition precedent to recovery.

III. Federal Kemper Insurance Company v. Hornback

A. Facts

In 1971, James and Mabel Hornback purchased a home in Elizabethtown, Kentucky for $3,150. The house was insured for $6,000, its contents for $4,000. On December 22, 1982, the Hornbacks, through an agent of Federal Kemper Insurance Company, submitted a claim for damages resulting from a fire. The insurance company denied the claim, stating that the Hornbacks had failed to comply with the terms of the policy. The Hornbacks subsequently filed a lawsuit against the insurance company, alleging bad faith in the handling of their claim.

35. 667 S.W.2d at 695.
37. See, Blue Cross & Blue Shield of Kentucky, Inc. v. Whitaker, 687 S.W.2d 557, 559 (Ky. Ct. App. 1985).
38. Id.
39. Id.
41. Feathers, 667 S.W.2d 693; American Centennial Insurance Company v. Wiser, 712 S.W.2d 345 (Ky. Ct. App. 1986), discretionary review denied July 28, 1986 (this case was decided only six weeks after Hornback).
42. Brief for Appellant at 1, Federal Kemper Insurance Company v. Hornback, 711 S.W.2d 844 (Ky. 1986).
43. Id.
pany, increased their insurance coverage to $30,000.\textsuperscript{44} The policy also provided a $15,000 limit on loss of contents,\textsuperscript{45} coverage for additional living expenses up to $6,000, and money for debris removal.\textsuperscript{46}

On January 26, 1983, the Hornback house and its contents were totally lost to fire.\textsuperscript{47} Strong evidence of arson was present,\textsuperscript{48} but there was little evidence that the Hornbacks had set the fire.\textsuperscript{49}

On March 22, with the assistance of counsel, the Hornbacks filed a proof of loss as to their home claiming the policy limit of $30,000.\textsuperscript{50} The policy limit of $15,000 as to contents was also claimed.\textsuperscript{51} The accuracy of the proof of contents loss was questioned by the insurance adjuster;\textsuperscript{52} as a result, the Hornback's bank records (with the Hornback's cooperation) were reviewed. Additionally, the Hornbacks were requested to submit to a statement under oath.\textsuperscript{53} Their statement was taken on May 5, 1983, five months after the fire.\textsuperscript{54} They also filed a $1,375 claim for debris removal and a claim for increased living expenses in the amount of $3,786.40.\textsuperscript{55} No part of the claim was satisfied, however, because of the suspected arson and misrepresentation.\textsuperscript{56}

Federal Kemper's refusal to pay forced the filing of a lawsuit on July 15, 1983, which sought $52,375 under the policy, and

\textsuperscript{44} Id. The $30,000 policy limit for the house was based on an appraisal made by an agent of the insurance company.
\textsuperscript{45} Id. Content coverage was 50% of structural coverage.
\textsuperscript{46} Brief for Appellant at 3, Federal Kemper v. Hornback, 711 S.W.2d 844 (Ky. 1986).
\textsuperscript{48} Id. There was a strong smell of gasoline on the premises, though the Hornbacks insisted that they did not store gasoline in their home.
\textsuperscript{49} Federal Kemper, 711 S.W.2d 844. The Hornbacks' alibis were strong.
\textsuperscript{50} Hornback, No. 83-CI-675 (Hardin Circuit Court, July 9, 1984) (opinion order to supplement judgment).
\textsuperscript{51} Id. The Hornbacks actually stated their content loss to be $26,000.
\textsuperscript{52} Brief for Appellant at 2, Federal Kemper, 711 S.W.2d 844.
\textsuperscript{53} Id.
\textsuperscript{54} Hornback, No. 83-CI-675 (Hardin Circuit Court, July 9, 1984).
\textsuperscript{55} Id.
\textsuperscript{56} On June 14, 1983, Federal Kemper's insurance adjuster retained a real estate appraiser to appraise the value of the Hornback's property as of the date of the fire. The house appraised out at a mere $13,500, $16,500 less than the amount determined when the insurance agent appraised it for the Hornbacks' newly acquired policy only 35 days before.
$7,500 in punitive damages based on the company's refusal to exercise good faith in the handling of the claim.\(^\text{57}\)

The contract claim was bifurcated from the claim of punitive damages and was tried first.\(^\text{58}\) The jury found for the Hornbacks in the amount of $50,161.40.\(^\text{59}\) In reaching this decision, the jury also found, based on its instructions, that the Hornbacks had not set fire to their house or made misrepresentations in their proof of loss.\(^\text{60}\)

Using the same jury, the claim for punitive damages was then tried.\(^\text{61}\) On this issue, the jury returned a verdict of $4,000.00,\(^\text{62}\) finding bad faith on the part of Federal Kemper. The defendant appealed the punitive damage award, arguing that the evidence of arson and misrepresentation had justified any delay in settling.\(^\text{63}\) The court of appeals disagreed.\(^\text{64}\) Using \textit{Feathers v. State Farm Fire \\& Casualty Company}\(^\text{65}\) as a guideline, the court stated:

\begin{quote}
In this case, appellant received a timely claim from appellees that satisfied the terms and conditions of its policy, so it had no excuse for withholding the proceeds unless there was substantial or credible evidence that the Hornbacks burned their home for personal gain. The evidence presented at trial clearly shows that appellees' residence was destroyed in a set fire, but there was little or no evidence linking either of them to the crime. Although appellant may have presented sufficient evidence to get its case to the jury, that level of proof does not constitute substantial or credible evidence as contemplated in \textit{Feathers}.... [T]he insurer incurs a duty to act in good faith towards its policyholders .... If the insurer makes no serious attempt to settle a valid, pending claim until forced into litigation, then a jury may find bad faith and may award punitive damages.\(^\text{66}\)
\end{quote}

In the court's opinion, "[t]he cause of action for tort based on the

\(^{57}\). \textit{Id.} at 3. On August 25, 1983, Federal Kemper offered the Hornbacks $26,575. This offer was refused. Later, on November 4, 1983, Federal Kemper offered the Hornbacks $40,000. This was also refused.

\(^{58}\). \textit{Brief for Appellant at 7, Federal Kemper}, 711 S.W.2d 844.

\(^{59}\). \textit{Id.} at 7-8. Actual cash value of residence, $30,000; policy limit for loss of contents $15,000; debris removal $1,375; and $3,786.40 in living expenses.

\(^{60}\). \textit{Hornback}, No. 83-CI-675 (Hardin Circuit Court, July 9, 1984).

\(^{61}\). \textit{Id.}

\(^{62}\). \textit{Id.}


\(^{64}\). \textit{Id.}

\(^{65}\). 667 S.W.2d 693 (Ky. Ct. App. 1983).

breach of covenant to act in good faith was sufficiently pled." 67 All concurred. 68 Federal Kemper appealed only on the judgment for punitive damages. 69 The Supreme Court of Kentucky granted discretionary review and reversed. 70

B. The Court's Opinion and Reasoning

In reversing the award of punitive damages, the court did not fault the trial court or the court of appeals, 71 because the lower court decisions had been tried and affirmed according to Feathers. 72 Feathers had held, under its facts, that the case before the court had been one involving "a pure first party contractual action alleging an independent tort arising from a wrongful breach," 73 i.e., "the breach [had been] so great that it constitute[d] tortious conduct on the part of the insurance company." 74 Therefore, at the time of the lower court's decision in Federal Kemper, the law provided a cause of action on which to base an award of punitive damages outside an action for mere breach of contract.

The Kentucky Supreme Court, however, found the rationale in Feathers to be lacking. This "new tort", it noted, classified insurers as fiduciaries and imposed an implied covenant of good faith and fair dealing on them. 75

In supporting this new tort, the court of appeals had cited the California case of Gruenberg v. Aetna Insurance Company 76 and the supreme court concluded that the appellate court's recognition of the new tort had apparently been based on a rationale borrowed from that case. 77 Accordingly, using the facts of Gruenberg, the court rejected this rationale and refused to hold that a first party action for breach of contract could be converted into a tort action by merely borrowing an analogy from the fiduciary

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67. Id.
68. Id.
69. Federal Kemper, 711 S.W.2d 844.
70. Id.
71. Id.
73. Id. at 696.
74. Federal Kemper, 711 S.W.2d at 845.
75. Id. See also, Gruenberg, 9 Cal. 3d 566, 510 P.2d 1032 (1973).
76. Federal Kemper, 711 S.W.2d at 845.
77. Third party bad-faith occurs when an insurance carrier fails to defend its insured in cases where the policy holder may be held liable for an amount in excess of the policy limits.
relationship found in third party cases and applying it to a first party situation.\textsuperscript{79}

The only fiduciary relationship we recognize attaching to insurance policies is the excess of the policy limit cases where good faith is required on the part of the insurance company\textsuperscript{80} ... [S]imilar cases cited therein, recognize these principles. This principle of law is contract and not tort and has no application to insurance contracts generally. Above all, there is no suggestion that punitive damages would follow breach.\textsuperscript{81}

Justice Stephenson concluded that there was no protection of the policyholder at issue in \textit{Feathers} or \textit{Federal Kemper} comparable to that at issue in \textit{Grundy}.\textsuperscript{82} Grundy was, in his view, a case of third party bad faith requiring the protection of the policyholder against a judgment larger than the policy limits. Therefore \textit{Feathers} was overruled.\textsuperscript{83}

Accordingly, after \textit{Kemper}, a failure or refusal to pay in first party situations will only give rise to a suit for breach of contract.\textsuperscript{84} The court felt that under its rules,\textsuperscript{85} sanctions against frivolous defenses would be sufficient to deter an insurer from a bad faith failure or refusal to pay first party benefits due and owing under an insurance policy.\textsuperscript{86}

Justice Vance concurred in a short opinion in which he observed that compensatory damages were adequate to make an insured “whole.” He regarded punitive damages as a windfall uncontrolled by any adequate standards for assessment, and which ultimately had no deterrent effect. In closing, Justice Vance called for further limitations, rather than an enlargement, upon the scope of punitive damages recovery, if, indeed, any change at all was to be contemplated.\textsuperscript{87}

Justice Leibson, joined by Stephens and Wintersheimer, dissented in an opinion more lengthy than that of the majority. In

\textsuperscript{78} Federal Kemper, 711 S.W.2d at 845.
\textsuperscript{79} Id., citing Gruenberg, 9 Cal. 3d 577, 510 P.2d 1032 (1973).
\textsuperscript{80} Id.
\textsuperscript{81} Id.
\textsuperscript{82} Id.
\textsuperscript{83} Id.
\textsuperscript{84} Id.
\textsuperscript{85} Federal Kemper, 711 S.W.2d at 845.
\textsuperscript{86} Id. at 846.
\textsuperscript{87} Id.
Justice Leibson's view, the majority had gone beyond the question presented in deciding that there was no cause of action in tort. According to the dissent, the true issue was "when will facts justify an award of punitive damages and more particularly, does the evidence . . . justify such an award." Justice Leibson concentrated his remarks on the subject of an appropriate legal standard for punitive damages (not unlike Justice Vance), and unequivocally demonstrated to the court that legal standards existed from which it could draw guidelines.

Sufficiency of the evidence being the true question, the issue of whether the dispute was tortious or merely contractual depended on proof of bad faith. This involved a determination as to whether the proof was sufficient for the jury to conclude that there was either conduct which was outrageous, or that the conduct demonstrated a reckless indifference to the rights of others. In Justice Leibson's view, the evidence, taken as a whole, supported the trial court's decision to submit the issue of punitive damages to the jury and, further, supported the jury's verdict. Justice Leibson stressed that the thrust of the Federal Kemper appeal had addressed the nature of the evidence and not whether the court should have overruled Feathers!

IV. ANALYSIS

In devouring the tort of first party bad faith, the court left a meager crumb for the injured plaintiff, a mere breach of contract action. In Kentucky, the damages for a breach of contract to pay money are the amount due under the contract plus interest, because, under this type of contract, only these damages are foreseeable at the time the contract is made. Extracontractual damages are those which include consequential and punitive damages as a result of breach, i.e., emotional distress, economic loss, and attorney's fees.

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89. Federal Kemper, 711 S.W.2d at 847.
90. Id. at 848-49.
91. Id.
94. Extracontractual damages are those which include consequential and punitive damages as a result of breach, i.e., emotional distress, economic loss, and attorney's fees.
95. McCarthy, supra note 10, at 83.
exceed the policy limits.\textsuperscript{96} The plaintiff has a right to be made "whole,"\textsuperscript{97} and to be put back in the position he would have been in had the insurance company paid him at the appropriate time. To limit recovery to a contract action alone is inadequate.

\textbf{A. The Contract}

1. \textit{Can We Really Bargain? (The Hook)}

Insurance contracts are not ordinary commercial contracts. Parties to insurance contracts seldom have equal bargaining power. "\textquoteleft\textquoteleft An insurance policy is a complex instrument, unilaterally prepared and seldom understood by the insured. The parties are not similarly situated. The company and its representative are experts in the field; the insured is not \ldots \textquoteright\textquoteright\textsuperscript{98} An insured does not contract for financial advantage, but to protect himself against loss. He is in a particularly vulnerable position if the situation arises where he must depend upon the insurer for economic stability and protection. An impecunious insured in this position is clearly susceptible to emotional distress if an insurance company fails to pay under the policy.

In this situation, the real question is what the insured intended to gain through his contract. It is reasonable to conclude that the insured contracted for money only indirectly, and subordinately to his main intention to contract for protection. The need for such protection was clearly foreseeable to the insured, and, as such, was bargained for. The reasonable expectation of the insured was for prompt payment in the event of misfortune as outlined under his policy. If such proceeds are not forthcoming, the insured stands to lose much more than he initially sought to protect.

Insurance promotes economic stability by enabling individuals to plan for circumstances which might otherwise be devastating.


Accordingly, the insurance industry becomes clothed with a public interest. It follows that the duty of an insurer is relational, not contractual, and therefore, that the insurer has a fiduciary relationship, that is, a personal relationship with the insured. This relationship heightens the company's duty to act in good faith.

The Federal Kemper Court's characterization of an insurance contract as merely a contract for the payment of money ignored the unique purpose of an insurance contract. Moreover, it presumed that the parties have equal bargaining power. But all things considered, is an insurance contract a mere contract for the payment of money? The answer is "no," at least not for the people that sought protection and thought they had it.

2. Are We Really Protected? (The Steal)

The Federal Kemper court stated: "The insurance company has an obligation to pay according to the terms of the contract. Failure or refusal to pay will give rise to a suit for breach of contract [only]." This opinion expressly precluded consequential and punitive damages, and only allowed damages in the amount of the policy limits, plus interest, at best. The gross inadequacy of such damages becomes clear when the facts of a case now pending in the Court of Appeals for the First District of Ohio are considered.

The case, Hammann v. Continental Casualty Company, was tried in Ohio but applied Kentucky law. The insured, Hammann, won at the trial court level. The court awarded the policy limits, punitive damages, attorneys fees, and costs. It was after this case was won at the trial court level that Federal Kemper was decided. On this basis, Continental Casualty Company (CNA) appealed, hoping to persuade the court to apply Federal Kemper

99. See infra note 97.
100. Id.
101. Id.
102. 711 S.W.2d 844 (Ky. 1986).
103. Id. at 845.
104. Id.
107. Id. The total award was $349,600.28.
retroactively to reverse the award of exemplary damages. A review of the facts will graphically show the need for a first party bad faith action under Kentucky law.

The store of William Hammann, Inc. (WHI), was gutted by a devastating fire on November 28, 1980. The fire was accidental in origin. William Hammann, Inc. was insured by CNA for $225,000, a twenty-five per cent seasonal adjustment, and coverage for business interruption.

On December 1, 1980, CNA's local adjuster, an insurance man of seventeen years, estimated the loss at $175,000. Nevertheless, CNA wanted a detailed counted salvage report, which was started on December 5, despite the fact that many items of merchandise were uncountable, and that a large amount of debris had already been removed. The value of the countable merchandise was established at $39,610.47. CNA also hired an accounting firm to audit WHI's books and records. The firm valued WHI's inventory at $147,301. CNA did not share either the salvage company's report or the accounting firm's report with its insured or its agent.

In an attempt to get back in business, WHI repeatedly requested an advance payment of $50,000 from CNA. This was not an unusual request. However, CNA refused to advance payment, even though this was urged by its own agents. As a consequence, in hopes of quickly getting back in business and resolving the claim, WHI hurriedly compiled, based on its own books and records, a proof of loss statement which it submitted to CNA on January 21, 1981. This statement, however, was

110. Id.
111. Id.
112. Id. at 3.
113. Id.
114. Id. at 5.
115. Id.
116. Id.
117. Id.
118. Id. at 5-6.
119. Id. at 6.
120. Id.
121. Id. at 7.
also rejected by CNA, for lack of documentary support. CNA refused to assist WHI in any way. It had decided within two or three weeks after the fire that the claim was to be "resisted." CNA ignored credible evidence, including reports from its own agents and retained accounting firm, which supported the legitimacy of WHI's claim.

On March 26, 1981, WHI filed a second proof of loss, in the amount of $135,896.14, this time supported by exhaustive documentation. CNA did not respond, even though the amount claimed was less than the initial estimate by CNA's agent and that of its retained accounting firm. In fact, CNA did not attempt to adjust WHI's claim at any time. As a result, WHI was forced into additional indebtedness, which contributed substantially to its eventual demise.

On August 4, 1981, nine months after the fire and without warning, CNA totally denied WHI's claim. In a letter addressed to William Hammann, CNA accused the insured of fraud and deceit. WHI filed for bankruptcy in December of 1981. "CNA intended to shoot and kill the corporation, and did. In the process, CNA also hit Bill Hammann."

3. What Are Our Remedies? (The Getaway)

Applying the rule of Federal Kemper to the situation in which Bill Hammann found himself would yield him only the limits of his policy. How can the Supreme Court of Kentucky conclude that this rule is fair, equitable, and adequate in a situation where an insurer engages in such outrageous conduct? In such a situation the insurer has nothing to lose and everything to gain by

122. Id.
123. Id.
126. Id.
127. Id.
128. Id. at 11.
129. Id. at 17.
131. Id. at 17.
delaying and/or denying any claim that comes before it. Moreover, the longer the company withholds proceeds, the more willing an insured will be to accept settlement offers which would be otherwise unacceptable, just to get back on his feet. An insured in this situation is truly in a needy position. Generally, he simply wants to put the incident behind him, get back on his feet, and continue with his life. The average insured is not willing to engage in a lawsuit, especially when he has limited financial and legal resources. For example, Bill Hammann originally filed his suit in 1981 and he is still involved in the lawsuit as of this writing. It seems that the whole purpose of insurance is defeated when an insurance company can refuse to pay without justification, and the only punitive consequence of such an action is the eventual possibility of having to pay the policy proceeds, plus interest, after the insured manages to bring a successful lawsuit.

B. The Resolution

1. The Better View

The better view is embodied in Justice Leibson’s dissent. “The question ... is not whether such a tort claim exists, but rather when will facts justify an award of punitive damages and, more particularly, does the evidence in the present case justify such an award?”133 The majority was overbroad when it overruled Feathers. The solution rests in establishing adequate guidelines to define bad faith in this situation, not in abolishing the cause of action.

The majority of the Federal Kemper court called this a “new tort,”134 when, in reality, it has been in existence since Gruenberg v. Aetna Insurance Company135 was decided in California in 1973, fourteen years ago! Every other jurisdiction recently called upon to decide this issue has recognized the principle that “given proper circumstances, an insured may pursue a tort claim against his own insurer for bad faith failure to pay first party benefits due and owing under the policy.”136 Kentucky, however, has taken

133. Federal Kemper, 711 S.W.2d at 846 (Leibson, J., dissenting).
134. 711 S.W.2d at 845.
136. Federal Kemper, 711 S.W.2d at 846 (Leibson, J., dissenting).
a quantum leap backward. Instead of seizing the opportunity to forge ahead, using *Feathers* as a basis for outlining clearer criteria with which to resolve existing ambiguities, the court fell back on old law.

The *Federal Kemper* rule is just not good enough for today's insurance situations. The court attempted to salve the insured's wounds with its observation that "sanctions for frivolous defense, as provided by our rules, are deemed sufficient to deter insurance companies from refusing to pay according to the terms of the contract without cause." However, the court's rationale of deterrence does not focus on making the insured whole. Granted, one of the purposes of punitive damages is deterrence; but by substituting the mere possibility of sanctions for an effective tort action, the court failed to recognize the wide pecuniary gap between recovery based on contract alone and recovery based on tort.

The tort action has nothing to do with deterrence, such is not its objective. The action's purpose is to make the insured whole, to put him in the position where he would have been had there insurance company paid the proceeds in good faith. Sanctions against the insurance company do not give the insured any direct remedy. He could only hope that by filing a lawsuit he would encourage the court to sanction the insurer, and thus deter the insurer from future bad faith. Once again, such a theory provides little risk for an insurer acting in bad faith, and even less of a remedy for its victim. The insurance company remains in a position to withhold proceeds in bad faith, thereby inflicting damages over and above policy limits. Even if the insured stays the course, and is successful, the insurer will ultimately be liable only to the extent of policy limits and, if the court sees fit, sanctions. This risk is not sufficiently consequential to deter big business.

The *Federal Kemper* majority needlessly took a feast or famine stance as regards the injured plaintiff. There is a happy medium to be had. Kentucky should retain the tort, but set guidelines to outline when, where, and under what circumstances, an insured may recover from an insurance company for its bad faith failure to pay. Justice Leibson observed that:

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137. 711 S.W.2d at 845.
The essence of the question as to whether the dispute is merely contractual or whether there are tortious elements justifying an award of punitive damages depends first on whether there is proof of bad faith and next whether the proof is sufficient for the jury to conclude that there was conduct that is outrageous, because of the defendant's evil motive or his reckless indifference to the rights of others. This, indeed, seems to be a better legal standard by which to judge first party bad faith actions.  

2. Guidelines  

Justice Leibson commended the insurer's counsel for locating citations to several cases that set out the proper standards for recovery of punitive damages when bad faith is alleged in insurance cases. These standards not only outline when punitive damages are recoverable, but also outline the circumstances in which there may be recovery in tort for bad faith. Recovery in tort for bad faith relies upon the premise that the law will imply a covenant of good faith and fair dealing in every contract, and that there is, therefore, a duty imposed on each party to refrain from interfering with the right of the other to recover the benefits of the agreement. When an insurance policy is involved, the "plaintiff must go beyond a mere showing of nonpayment and prove a bad faith nonpayment, a nonpayment without any reasonable ground for dispute."  

One guideline suggested by a Wisconsin court, and mentioned by Justice Leibson in his dissent, states that an insured must prove three elements to prevail against an insurance company for an alleged refusal to pay the insured's claim in good faith:  

(1) The insurer must be obligated to pay the claim under the terms of the policy; (2) the insurer must lack a reasonable basis in law or fact for denying the claim; and (3) it must be shown that the insurer either knew there was no reasonable basis for denying the claim or acted with reckless disregard for whether such a basis 

138. Id. at 848 (as quoted and applied in Horton v. Union Light, Heat & Power Co., 690 S.W.2d 382, 288-90 (Ky. 1985)).  
140. Federal Kemper, 711 S.W.2d at 846 (Leibson, J., dissenting).
This standard closely correlates with that set out in Feathers. Admittedly, there is a fine line between tortious and non-tortious conduct and, therefore, liability must be based on a case by case analysis. An insured need only prove the breach of the covenant of good faith and fair dealing. This is less of a burden than is imposed under other tort theories and should give the court and the parties latitude to be creative in carving out an appropriate standard.

V. Conclusion

The “now you see it, now you don’t” action of the Kentucky Supreme Court in withdrawing its recognition of the fiduciary relationship between an insurance carrier and an insured yields a harsh result. It leaves insureds like Bill Hammann without a remedy by which they can be made “whole.” Insurance is more than a form of banking; an insured party is seeking protection. When that protection is not promptly available in a time of need, the insured, already in a vulnerable position, is further exposed to the exact types of harm from which he sought to protect himself. A bad faith refusal to pay is tortious in nature, not merely a breach of contract. Therefore, the imposition of extra-contractual (tort) liability upon insurers who wrongfully delay or refuse to make payments of insurance benefits is necessary. The Kentucky Supreme Court should recognize the need to balance the relative interests of the insurer and the insured. This calls not for abolishment of the cause of action in tort recognized in Feathers for an insurance company’s damage to the insured when it refuses to pay a claim in bad faith, but for a clear standard by which to measure bad faith in this situation.

The Court should consider the plight of plaintiffs like Bill Hammann. “Whether the insured is an innocent or an arsonist, he is generally unable to sustain the economic burden of such

143. See generally, Toner, In the Wake of Federal Kemper: First Party Claims for Bad Faith/Punitive Damages, Ky. Bench & B. at 23 (Summer 1986).
144. Federal Kemper, 711 S.W.2d at 849 (Leibson, J., dissenting).
[losses]. Even an award of punitive damages, after contingency fees and costs are deducted, may not make the insured whole.”

Kentucky, in limiting the scope of an insurer's liability, denies helpless policyholders a remedy for the damages caused by insurance companies that take advantage of the very people that they have contracted to protect.

The tort remedy for first party bad faith needs to be revived and guidelines established for its effective application. In shaping these guidelines, the Court should put itself in the shoes of an insured when it assesses the impact of insurance company misconduct. In doing so, the Court should consider the mental and emotional vulnerability that is an integral part of the insurance contract. The Court should recognize the fiduciary relationship existing between an insured and an insurer. Only by recognizing this relationship can the court fashion a truly appropriate remedy.

DEBORAH BATTLE HOULISTON*

145. Toner, supra note 143, at 25.
* I would like to thank Ronald R. Parry for his extensive knowledge, insight, and guidance.
I. INTRODUCTION

Ms. Gene Arline, an elementary school teacher in Nassau County, was discharged after having three relapses of tuberculosis within a two year period.1 Her initial hospitalization for the disease occurred twenty years prior to the relapses at issue when the tuberculosis once again became active.2

Tuberculosis is an infectious disease that can have certain physical manifestations and may impair the respiratory system of afflicted individuals.3 According to Dr. McEuen, a tuberculosis specialist who testified at trial, the disease can be transmitted by coughing, sneezing or other respiratory activity and young children are particularly susceptible to contracting it.4

The school board justified Arline's dismissal on grounds of public health and the welfare of the students.5 Arline argued that her condition qualified her as a handicapped individual under the Rehabilitation Act of 1973 and that her discharge was in violation of section 504 of the Act.6

The Supreme Court was faced with two novel inquiries regarding the operation of the Rehabilitation Act where a contagious disease is involved. First, the Court had to determine whether a person suffering from the communicable disease of tuberculosis may be considered to be a "handicapped individual" within the meaning of section 504. Having decided that she may,7 the Court then turned to the question of whether the contagiousness of her disease kept her from being "otherwise qualified" to teach elementary school. The case was remanded to the district court for a determination of this issue.8

2. Id. at 1125.
3. Brief for Petitioner at 17, Arline.
4. Id. at 4.
5. Id. at 5.
7. Id. at 1130.
8. Id. at 1132.
II. BACKGROUND

A. Legislative History

In an effort to provide assistance for handicapped individuals to realize "their full potential for participation" in society, Congress enacted legislation in the area of rehabilitation services for the handicapped. Section 504 of the Rehabilitation Act of 1973 prohibits discrimination against the handicapped by providing:

No otherwise qualified handicapped individual in the United States, as defined in section 706(7) of this title, shall, solely by reason of his handicap, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any program or activity receiving federal financial assistance or under any program or activity conducted by any executive agency or by the United States Postal Service. 11

In an amendment to section 706(7) in 1974, the term "handicapped individual" was defined as "any person who (i) has a physical or mental impairment which substantially limits one or more of such person's major life activities, (ii) has a record of such an impairment, or (iii) is regarded as having such an impairment." Alcoholics or drug abusers whose conditions are a direct threat to others are specifically excluded from section 504 protection. The words in subsection (i) referring to an impairment substantially limiting "major life activities" is a change from the original language that sought to define a handicapped individual in terms of his "functioning." It is apparent then, that it was the intent of Congress to protect against discrimination those persons whose major life activities are impaired by their handicap and that it was not Congress' intent to extend general protection to all individuals

13. Id.
with non-disabling afflictions. However, if an individual suffers from discrimination based upon a perceived handicap, he is a member of the protected class regardless of whether or not he does, in fact, suffer from an actual impairment.\textsuperscript{15}

In order to more fully understand the import of the language of these sections, it is useful to look to the regulations promulgated by the Department of Health, Education, and Welfare (HEW) and the Department of Labor in cooperation with the Senate Committee on Labor and Public Welfare and the House Committee on Education and Labor. These regulations were passed in order to "insure that implementation of the provisions of the [Rehabilitation] Act would be accomplished in accordance with the intent of Congress."\textsuperscript{16} More specifically, the HEW rules lend insight into congressional intent concerning the operation of section 504 of the Rehabilitation Act of 1973 by providing more particularized definition of the terms "physical or mental impairment,"\textsuperscript{17} "major life activities,"\textsuperscript{18} and "qualified handicapped person."\textsuperscript{19}

The impairments dealt with by these regulations include physiological disorders, disfigurement and anatomical loss as well as psychological disorders and specific learning disabilities.\textsuperscript{20} The major life activities which must be substantially limited by these impairments before they are recognized as handicaps involve such things as "caring for one's self, performing menial tasks, walking, seeing, hearing, speaking, breathing, learning, and working."\textsuperscript{21} Quite clearly, the Rehabilitation Act was intended to address a wide range of handicaps.

\textbf{B. Private Right of Action}

The Act directs federal agencies and recipients of federal assistance to avoid discrimination in hiring handicapped persons, and it provides that there is also a private right of action under

\begin{itemize}
\item \textsuperscript{15} 29 U.S.C. §§ 706(7)(B)(iii). \textit{See also}, Southeastern Community College v. Davis, 442 U.S. 397, 405-6 n.6 (1979).
\item \textsuperscript{17} 45 C.F.R. 84.3(j)(2)(i) (1986).
\item \textsuperscript{18} 45 C.F.R. 84.3(j)(2)(ii).
\item \textsuperscript{19} 45 C.F.R. 84.3(k)(1) (1986).
\item \textsuperscript{20} 45 C.F.R. 84.3(j)(2)(i).\textsuperscript{21} \textit{See also}, Oesterling v. Walters, 760 F.2d 859 (8th Cir. 1985).
\end{itemize}
section 504. 22 To prevail under a section 504 claim, the plaintiff must show: (1) he is a “handicapped individual” as contemplated by the Act, (2) he is “otherwise qualified” for the position he sought, (3) he was excluded solely by reason of his handicap, and (4) the program or activity in question is either federally administered or a recipient of federal financial assistance. 23 Once the plaintiff has established his prima facie case, the burden shifts to the employer to rebut an inference of impropriety by bringing forward evidence that the handicap is relevant to the requirements of the position sought. 24 The ultimate burden, however, is on the plaintiff to show that he is “otherwise qualified” for the job. 25

The HEW regulations define a “qualified handicapped person” within the context of employment as one who, “with reasonable accommodation, can perform the essential functions of the job in question....”26 The United States Supreme Court has held that “[a]n otherwise qualified person is one who is able to meet all of a program’s requirements in spite of his handicap.”27 The omission of the word “otherwise” from 45 C.F.R. 84.3(k)(1) indicates that it was Congress’ intent to extend protection only to those who are qualified for an employment in spite of their handicap and not those qualified except for their handicap. 28

This determination is to be made based upon reasonable accommodation of the individual. 29 An illustrative, although by no means exclusive, list of steps which are considered to be reasonable accommodations and factors for determining undue hardship are set out in the HEW regulations to the Rehabilitation Act. 30

24. Id. at 776-77.
25. Id.
26. 45 C.F.R. 84.3(k)(1).
27. Davis, 442 U.S. at 406 (emphasis added).
28. Id. at 407 n. 7.
29. Mantolete v. Bolger, 767 F.2d 1416, 1423 (9th Cir. 1985).
30. 45 C.F.R. 84.12 (1986).
Such accommodations, however, need not go so far as to amount to a substantial modification of an institution’s program.\footnote{31}

While there is a great deal of instructive commentary in the act regarding its purposes and terms, the statute is silent with respect to contagious diseases. Nowhere in the Act or in the HEW regulations is there a treatment of, or reference to, individuals afflicted with a contagious disease.

In 1979, one jurisdiction, the United States Court of Appeals for the Second Circuit, dealt with a case involving the isolation of mentally retarded students, who were known to be carriers of hepatitis B, from the remainder of student body.\footnote{32} However, the issue of contagiousness and its relationship to section 504 was not fully addressed by the court. This was because the virus involved was of a type that could not be communicated without being introduced directly into another person’s bloodstream. Since the classroom environment did not involve that particular type of contact, and since no attempt has been made to determine if other children in the school had the disease,\footnote{33} the case was primarily concerned with discrimination against those with mental handicaps and not those with a contagious virus. Consequently, neither this or any other court had previously addressed the issues later faced by the Supreme Court in the Arline case.

III. **School Board of Nassau County v. Arline**\footnote{34}

Justice Brennan, writing for the Court in Arline, began with a treatment of the legislative history of the Rehabilitation Act of 1973 and its subsequent amendments. Within this framework, the Court had to determine whether Arline’s condition constituted a “handicap” under section 504 and whether the contagiousness of her disease prevented her from being “otherwise qualified” to teach elementary school children. The Court remanded the case to the district court regarding the latter issue after reaching a decision favorable to Arline on the former.

While the Court agreed that a contagious disease which diminished the physical or mental capabilities of the infected person

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33. Id. at 649.
may constitute a "handicap" under section 504, they were not prepared to separate the contagiousness of the disease from its debilitating physical effects.\(^{35}\) To make such a distinction would, in the view of the Court, provide employers with a reason for not hiring handicapped individuals without having to acknowledge that such discrimination was based upon the handicapping condition itself.\(^{36}\)

According to the majority, any judicial interpretation permitting such a loophole would be "inconsistent with the basic purpose of section 504, which is to ensure that handicapped individuals are not denied jobs or other benefits because of the prejudiced attitudes or the ignorance of others."\(^{37}\) Given that the contagiousness, or perceived contagiousness, of certain illnesses generally leads to public misapprehension or panic, the Court was concerned that a blanket exclusion from section 504 protection of all individuals who were afflicted with either actual contagious disease, or with conditions perceived to be contagious, would leave such persons without the opportunity to establish that they were "otherwise qualified" to participate in the employment that had been denied them\(^{38}\). There could never be recovery for those individuals who, under such an exclusion, were both contagious and otherwise qualified because, before reaching a determination as to the latter, the plaintiff must first make a prima facie showing that she is handicapped under section 504.\(^{39}\)

The Court concluded that "the fact that a person with a record of physical impairment is also contagious does not suffice to remove that person from coverage under section 504."\(^{40}\) However, the majority also opined that the determination of whether the contagiousness of the disease would prevent the individual from being "otherwise qualified" needs to be made at the district court level on a case-by-case basis.\(^{41}\)

The Court was persuaded by an amicus brief from the American Medical Association arguing that the inquiry of district courts should include:

\(^{35}\) Id. at 1128.
\(^{36}\) Id.
\(^{37}\) Id. at 1129.
\(^{38}\) Id. at 1129-30.
\(^{39}\) Id.
\(^{40}\) Id. at 1130.
\(^{41}\) Id. at 1131.
The Court directed that once findings have been made as to the above factors, an evaluation must be made as to "whether the employer could reasonably accommodate the employee under the established standards for that inquiry." By this direction, the majority intended that credence be given to the Court's prior discussion of reasonable accommodation in *Southeastern Community College v. Davis* and to the factors listed in the HEW guidelines.

Applying the foregoing standards to Ms. Arline, the Court found that her tuberculosis qualified as a physical impairment covered by the Act since it had a detrimental effect on her respiratory system. Given that each of the recurrences of the active stage of her disease required a period of hospitalization, the Court determined further that one of her major life activities had been substantially impaired by her condition. Thus, it concluded, her condition qualified her as a handicapped individual as defined in section 706(7)(B) of the Act. However, insofar as necessary findings and evaluation had not been undertaken by the district court regarding the contagiousness of her disease, the Supreme Court found it necessary to remand the case for such determinations to be made in order to resolve the question of whether Arline was qualified, despite her tuberculosis, to continue in her position as an elementary school teacher.

IV. ANALYSIS

In order to avoid confusion, it is important, before proceeding, to emphasize the narrow holding of *Arline* and to indicate what

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42. *Id.* citing Brief for American Medical Association as Amicus Curiae 19.
43. *Id.*
44. *Id.* at 1131 n. 17.
45. *Id.* at 1127.
46. *Id.*
47. *Id.* at 1132.
issues have not been addressed by the Court. Specifically, the Arline Court held that a person with the contagious disease of tuberculosis can be a "handicapped individual within the meaning of section 504 of the Rehabilitation Act of 1973. . . ."48 The issue which the Court did not decide is whether a person with a contagious disease may be considered a "handicapped individual" solely by virtue of the communicability of her illness.49 However, a careful reading of the Court's rationale and dicta may give some indication as to how the latter issue may be resolved in future cases.

The Court devoted a great deal of time underscoring the purposes of the Rehabilitation Act and pointing out that the subsequent amendments to the Act reflected a deepening concern for protecting certain individuals from the prejudicial fears of others.50 Congress itself has been careful, in discussions concerning each successively liberal amendment, to point out that the evil guarded against is the unjustifiably discriminatory practice of excluding certain persons from participation in programs or from employment opportunities solely on the basis the subjective, and often irrational, reactions of society to various medical conditions.51

The Act does not prohibit all exclusion of handicapped persons from employment or participation, but rather mandates that handicapped individuals otherwise qualified for a position should be given reasonable accommodation and should not be excluded on the sole basis of their handicaps.52 Instead, they must be given the opportunity to show that they are capable of carrying out the responsibilities of the position despite their handicaps.53

While Arline's condition was both physically manifested and communicable, it was the effect of the disease on her respiratory system, that is, the physical manifestation, that brought her within the realm of section 504 protection; the Court merely refused to let her contagiousness remove that threshold assessment. Moreover, it can be predicted that, if it is confronted with a

48. Id.
49. Id. at 1128 n.7.
50. Id. at 1128-29.
52. 29 U.S.C. §§ 794.
53. Id.
factual situation in which the person claiming protection is a carrier of an infectious disease, but has no physical symptoms of the disease itself, the Court is still likely to hold that such an individual is also covered by section 504.

The basis of this prediction is the Court's recognition of the powerful effects of societal fears and prejudice. Often, social reaction to an affliction proves to be more of a handicap than the affliction itself. Recognizing this, Congress included within section 504 persons who had suffered from a qualifying condition in the past but who were no longer physically incapacitated. An even stronger indication of Congress' overriding concern with irrational social reaction is that it went even further and included not only those who were no longer physically incapacitated, but also those who never had been — those who had merely been falsely perceived as incapacitated.

Carriers of infectious diseases are susceptible to much the same type of adverse repercussions as the actual or perceived sufferer of a physical handicap. The general public is often mistaken as to how various diseases may be communicated. Throughout history, society has treated certain classes of non-contagious diseases, such as cancer and epilepsy, as contagious to at least some degree. If these carriers, or perceived carriers, are per se excluded from section 504 protection, then those merely accused of being contagious, or whose contagiousness could be maintained or controlled with reasonable accommodation, will never have the opportunity to have their qualifications to work assessed in an objective manner. This is precisely the consequence, even though based on different facts, that the Arline Court sought to avoid and the rationale employed by the Court would be equally appropriate in such a circumstance.

Rather than to tolerate discrimination based upon unfounded subjective fears, the majority elected to treat inclusion under section 504 as a threshold protection and to make it available in a wide range of circumstances in order to ensure that the abilities of an individual would be objectively balanced against the legit-

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54. Davis, 442 U.S. at 406.
imate public concerns of health and safety. The same approach is applicable in balancing the rights of an infectious person against legitimate societal concerns. Including infectious person under section 504 does not automatically ensure that they will not be refused work; the showing of qualification despite the infectious condition is still the critical requirement.

The Court recognized that certain diseases have a greater risk of being communicated than others and that certain individuals or classes of people have a greater risk of contracting the disease once exposed. If these risks cannot be maintained within an acceptable level, then an infected person may be excluded, notwithstanding that she may suffer from a qualifying physical impairment. To include those persons who suffer from contagious diseases but who have no accompanying physical disabilities within the realm of section 504 protection is logically consistent with the Court's reasoning in refusing to allow the communicability of a disease to remove otherwise vested protection. Social interests of public health and safety would still be considered in exactly the same manner and to the same degree under the "otherwise qualified" determination, regardless of whether or not the individual's initial inclusion within the Act's coverage was predicated on physical impairment or on an actual or perceived state of contagiousness.

V. CONCLUSION

Future applications of the Rehabilitation Act of 1973 will likely extend protection to persons who are exposed to social injustices solely because of society's fear of communicable diseases. While the Act does not expressly deal with contagious illnesses which are not physically manifested, the purposes of the Act, as indicated by Congress and recognized by the Arline majority, are broad enough to incorporate this category. The policy arguments articulated by the Court in Arline suggest that the Court is likely to rule that persons in this category would be protected on the threshold level by section 504 and that an objective determination

59. Id. at 1130.
60. Id. at 1131.
61. Id.
must be made as to whether or not their contagiousness prevents them from otherwise qualifying for a particular job.62

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62. Id. at 1131 n. 16.
I. INTRODUCTION

The Rules of Civil Procedure governing physical and mental examinations of persons in Kentucky are contained in CR 35.01 and CR 35.02. Contrary to popular belief among those in the legal profession, Kentucky's Rule 35 does not grant a defendant an absolute right to have the plaintiff examined by a physician. Civil Rule 35.01 states:

When the mental or physical condition (including the blood group) of a party, or of a person in the custody or under the legal control of a party, is in controversy, the court in which the action is pending may order the party to submit to a physical or mental examination by a physician or to produce for examination the person in his custody or legal control. The legal order may be made only by motion for good cause shown and upon notice to the person to be examined and to all parties and shall specify the time, place, manner, conditions, and scope of the examination and the person or persons by whom it is to be made. (Amended effective October 1, 1971.)

Most defense attorneys are under the mistaken belief that CR 35.01 compels a court to order a physical or mental examination of a party when his physical or mental condition is in controversy. Many defense attorneys also presume that the plaintiff's attorney has no right to object to the doctor chosen by them for medical evaluation. Such attorneys usually contend that it would be an absolute absurdity not to allow them to choose their own doctor since the plaintiff's attorney has the right of cross examination to bring out any possible bias or prejudice.

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4. Based upon the reading of various Motions for Physical Examination.
The law in Kentucky is clearly to the contrary. CR 35.01 has never been interpreted (either expressly from its terms or through case analysis) to disallow a plaintiff to object to a defendant's choice of physician.

On the contrary, it is well settled that, even where an examination is appropriate, the defendant has no absolute right to choice of physician. CR 35.01 provides that when the mental or physical condition of a party is in controversy, the court in which the action is pending "may" order the party to submit to a physical or mental examination by a physician. The Rule further requires that an order shall only be made for good cause shown and upon notice to the examinee. Accordingly, such an order is completely discretionary with the court.

One of the most troubling aspects of research involving Kentucky procedural law is a lack of in-state case law or detailed treatises on the subject. Consequently, Kentucky decisions rely heavily on federal precedents and the major treatises on federal law in interpreting the Kentucky Rules of Civil Procedure. Although there are state sources available to help interpret the rules, frequently they are not detailed enough to solve a problem of first impression in Kentucky.

As a result, the most helpful approach toward interpreting Kentucky's Civil Rules is to first review how the Federal Rules of Civil Procedure (FRCP) have been construed. "Kentucky cases often cite as authority federal rules' decisions by the federal courts."

Kentucky courts seek parity between the state and federal rules in order to promote consistency between the federal and state courts of Kentucky, and to avoid the creation of snares for the unwary lawyer who attempts to practice at both levels of


6. BERTELSMAN & PHILLIPS, KENTUCKY PRACTICE, Civil Rule 35.01 (4th ed.).

7. KY. R. CIV. P. 35.01.

8. Id.


10. Id.

11. Id., n.3. See also Scudamore v. Horton, 426 S.W.2d 142, 144 (Ky. 1968) (citing federal district court decisions); Jackson & Church Div., York-Shipley, Inc. v. Miller, 414 S.W.2d 893, 894 (Ky. 1967) (citing federal district court decisions); Jackson v. Metcalf, 404 S.W.2d 793, 794 (Ky. 1966) (citing United States Supreme Court).
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jurisdiction. Considering that CR 35.01 was amended effective October 1, 1971 to conform to the 1970 amendment of FRCP 35(a), making their provisions identical, an analysis of Kentucky Rule 35 through both federal cases and Kentucky cases is appropriate.

II. Case Analysis

Although there are both federal and Kentucky cases directly on point in holding that a defendant does not have an absolute right to choice of physician under Rule 35, a 1964 Supreme Court decision provides an excellent overview of the general requirements of the Rule. In Schlagenhauf v. Holder, bus passengers were injured when the bus in which they were traveling rear-ended a tractor-trailer. The passengers sued the bus company, the bus driver, the tractor-trailer owners, and the truck driver in the United States District Court for the Southern District of Indiana. In their cross-claim against the bus company, the tractor-trailer owners alleged that the bus driver had not been mentally or physically competent to safely operate the bus due to his impaired vision.

At this point, the tractor-trailer owners petitioned the court for examination of the bus driver under FRCP 35. The district court ordered examination. In response, the bus driver applied for a writ of mandamus to set aside the order. Although the writ was denied by the United States Court of Appeals, the Supreme Court heard the case on certiorari.

Resolution of the issue before the Supreme Court turned on the validity and construction of Rule 35 as applied to the examination of a defendant in a negligence action. Accordingly, before the Court could expound upon the construction of the language of Rule 35, it had to first determine whether the Rule applied to both plaintiffs and defendants in the action before it.

12. Id. at 551-52.
13. BERTELSMA, supra note 6, at 643.
15. Id. at 106-08.
16. Id.
17. Id. at 107.
18. Id. at 108-09.
19. Id. at 106.
20. Id. at 110.
This was an issue of first impression requiring a determination as to the construction and application of the Rule in a new context. Therefore, the Court began its analysis by stating, "Rule 35 on its face applies to all parties, which under any normal reading would include a defendant." While recognizing that this type of discovery had been utilized in the past solely against plaintiffs, insofar as reported cases revealed, the Court nevertheless held that Rule 35 applied to either party, was free of constitutional difficulty, and was within the scope of the Enabling Act.

When determining the construction of deposition-discovery rules, the courts must accord them "a broad and liberal treatment." According to the express terms of Rule 35, the mental or physical condition of the party to be examined must be "in controversy" and "good cause" must be shown for the court to order the examination. These two requirements of Rule 35 are not mere formalities which can be met by the simple addition of conclusory allegations to the pleadings. There must be an "affirmative showing by the movant" that issues relating to the examination are "really and genuinely in controversy and that good cause exists for ordering each particular examination."

With this in mind, trial judges must decide with "discriminating application" whether the requesting party has adequately met the Rule's requirements of "in controversy" and "good cause." Although the federal rules are to be liberally construed, the courts can not disregard plainly expressed limitations and requirements. While the movant is not required to prove his case on the merits to satisfy Rule 35, he may have to submit affidavits, or other matter to satisfy this requirement.

Many in the legal profession credit the Schlagenhauf case for putting a stricter limit on the defendant's ability to have a plaintiff routinely examined even where the circumstances of the

21. Id. at 111.
22. Id. at 112.
23. Id. at 114.
24. Id. at 114-15.
26. 379 U.S. at 118.
27. Id. at 118-19.
28. Id. at 119.
case revealed no need for it. This is because Schlagenhaft strictly adhered to the requirements set forth in the wording of Rule 35. Writing for the majority in that case, Justice Goldberg specifically held that the "good cause" and "in controversy" requirements of Rule 35 make it very apparent that examinations of a party "are not to be automatically ordered merely because the person has been involved in an accident." In his concluding statement, Justice Goldberg provided even more explicit notice of the limitations upon a party's ability to have his opponent automatically examined:

Mental and physical examinations are only to be ordered upon a discriminating application by the district judge of the limitations prescribed by the Rule. To hold otherwise would mean that such examinations could be ordered routinely in automobile accident cases. The plain language of Rule 35 precludes such an untoward result.

With Schlagenhaft setting out the basic requirements that must be met for a court to sustain a motion for physical or mental examination under Rule 35, the only question remaining is whether a party can object to the other's choice of physician. Analysis of a long line of federal and Kentucky cases brings one to the logical conclusion that such objections are proper and may be sustained by the trial court.

In Gitto v. Societa Anonima Di Navigazione, Genova, the district court directly addressed the issue. The facts of the case were quite simple. The defendant made a motion under Rule 35 to have the infant plaintiff submit to the taking of x-ray pictures by a physician named by the defendant. Controversy arose when the plaintiff objected to the defendant's choice of physician and requested that the court appoint an impartial physician. Thus, the issue presented was whether a defendant seeking a physical examination under Rule 35 has the privilege of naming his own physician.

30. 379 U.S. at 121.
31. Id. at 121-22.
32. BERTELSMAN, supra note 6, at 644.
33. 27 F. Supp. 785 (E.D.N.Y. 1939).
34. Id. at 786.
35. Id.
The district court was explicit in holding that the wording of Rule 35 made it readily apparent that whether a physical examination should be granted rests entirely within the discretion of the court.\(^{36}\) The court reached this conclusion because the language of FRCP 35 used the term “may”, obviously indicating that it is discretionary with the court whether to order an examination or not. Judge O’Brien stated, “[T]he Rule is phrased in terms of ‘may’, not ‘must’ and ‘shall.’”\(^{37}\) It should be noted that Kentucky’s CR 35.01 also uses the term “may.”

The \textit{Gitto} court explained that the wide range of discretion vested in the court made it obvious “that a defendant seeking a physical examination of a plaintiff has \textit{no absolute right to the choice of his own physician}.”\(^{38}\) Even if a court determines that a physical examination should be conducted, it remains in its discretion to determine the physician who shall conduct it.\(^{39}\)

A court can, in its discretion, appoint the physician chosen by the defendant if the Court finds that “the interest of justice will best be served in that manner.”\(^{40}\) Conversely, as in \textit{Gitto}, the district court may hold that it is best to appoint another physician.\(^{41}\) The only reason alluded to by the \textit{Gitto} court for its determination was the fact that the plaintiff had made “strenuous objection” to the defendant’s choice of physician.\(^{42}\) The court stated further, “[I]f the parties can select a physician mutually agreeable, his name may be submitted. If not, the court will make its own choice.”\(^{43}\)

The \textit{Gitto} case seems to have made it explicit clear that the other party has the right to object to the movant’s choice of physician, and that such objection is enough to require both parties to either agree on a physician or have the court appoint an impartial one. “The comments of the Supreme Court advisors confirm \ldots that the Court exercises full discretion in regulating and controlling physical and mental examinations.”\(^{44}\)

\begin{footnotes}
36. \textit{Id.}
37. \textit{Id.}
38. \textit{Id.}
39. \textit{Id.}
40. \textit{Id.}
41. \textit{Id.} at 787.
42. \textit{Id.}
43. \textit{Id.}
44. \textit{Id.} at 786.
\end{footnotes}
Liechty v. Terrill Trucking Co.\textsuperscript{45} and Leach v. Grief Bros. Cooperage Corporation\textsuperscript{46} are two federal cases decided after the Gitto decision. Both Liechty and Leach reaffirmed and upheld Gitto's rationale and conclusions, thereby strengthening its precedential value.

The facts in Liechty were very similar to those in Gitto in that both cases involved a defendant moving the court to order a plaintiff (or plaintiffs) to submit to a physical and/or mental examination under Rule 35. After disposing of the notice requirement set out in Rule 35 by stating that mere service of a copy of the motion upon adversary counsel is insufficient, the district court then addressed the issue at hand.\textsuperscript{47}

Judge Reese stated that it was usual procedure for physical examinations under Rule 35 to be made with the "agreement of the party to be examined."\textsuperscript{48} The court went on to state that Rule 35 only stood as a compulsory requirement once a doctor was agreed upon by counsel for both parties. This court reaffirmed that the defendant had no absolute right to the choice of his own physician and that a valid objection to the selection would suffice to either cause the court to select a physician or have the parties mutually agree upon one.\textsuperscript{49}

The Leach case was decided two years after Gitto and twenty-nine years prior to Liechty. Although the Leach court did not accept the principles elucidated in Gitto as readily as the Liechty court later would, the case still has some precedential value in that it indicates the judicial system's willingness to liberally construe the Rules of Civil Procedure in general, while keeping a limited perspective regarding Rule 35 in particular. This construction prevents surprise and delay and affords both parties the "widest latitude in ascertaining before trial facts concerning the real issues in dispute and to eliminate as much as possible all expense and difficulty that could be involved in the procuring of documents at trial."\textsuperscript{50} Thus, while recognizing a need for liberal construction of the Rules to expedite matters, the Leach court

\textsuperscript{45} 53 F.R.D. 590 (E.D. Tenn. 1971).
\textsuperscript{46} 2 F.R.D. 444 (S.D. Miss. 1942).
\textsuperscript{47} 53 F.R.D. at 591.
\textsuperscript{48} Id.
\textsuperscript{49} Id.
\textsuperscript{50} 2 F.R.D. at 446.
qualified this need as it applied to Rule 35 by holding, "the right under the rules does not go so far as to permit the moving party to name the physician to make the examination. That is a matter left to the sound judgment of the court." 51

Although no Kentucky case has been decided exactly on this point, it seems apparent that the Kentucky courts would follow the federal courts in holding that a moving party has no absolute right to the choice of a physician. This is especially true since Kentucky's Rule 35 has been amended to the identical form of the Federal Rule. 52

In the fourth edition of Kentucky Practice, Judge Bertelsman and Kurt Phillips provide a thorough analysis of Rule 35. After discussing both the principal changes made by the 1971 amendment and what is required by the express terms of the Rule, the authors offered their own detailed analysis. Although there is no limitation on the actions in which the Rule can be used, the authors are of the opinion that there is still some question as to "whether or not the physical or mental condition of a party must be immediately and directly in controversy." 53

The authors reasoned that since the overall objective of Rule 35 is to determine the truth of the matter in controversy and since the Rule grants so much discretion to the courts, it is not necessary to limit its application to any rigid set of circumstances. 54 An early Kentucky case had set out the guiding principles. Belt Electric Line Co. v. Allen, 55 was the first Kentucky decision to address the issue of whether a plaintiff in an action for damages for permanent injuries may be required to submit to a medical examination. The Court of Appeals reasoned that, although trial courts have the power to order the expert physical examination of a plaintiff seeking to recover for personal injuries, the defendant has "no absolute right" to have the plaintiff examined; the decision is within the sound discretion of the court. 56 Judge Hazelrigg further concluded:

The examination should be ordered and had under the direction and control of the court, whenever it fairly appears that the ends

51. Id.
52. BERTELSMAN, supra note 6, at 643.
53. Id.
54. Id.
55. 44 S.W. 89 (Ky. Ct. App. 1898).
56. Id.
of justice require the disclosure or more certain ascertainment of facts which can only be brought to light or fully elucidated by such an examination, and that the examination may be made without danger to the plaintiff's life or health, and without the infliction of serious pain.\textsuperscript{57}

After \textit{Belt Electric} broke the ice by not allowing physical examination to be routinely ordered in every case, other Kentucky decisions soon followed suit. In \textit{Conley v. Jennings}, the trial court overruled the defendant's motion for physical examination because of the "extremely nervous condition" of the plaintiff and because she was "suffering from the injuries she received in the accident."\textsuperscript{58} The Court of Appeals of Kentucky held that under the circumstances (the condition of the plaintiff), the trial court did not abuse its discretion in overruling the motion.\textsuperscript{59} The court reasoned, "in all cases, a motion to require an injured person to present himself at a hospital for examination adresses itself to the sound discretion of the court."\textsuperscript{60}

In \textit{Belt Electric}, the court had hinted that there must be a real dispute concerning the condition of the plaintiff to warrant his further examination by court order. Moreover, in deciding whether to issue an order for physical examination, the court must also determine whether a more certain ascertainment of facts relevant to the case could be derived through the requested physical or mental examination.\textsuperscript{61} This view was further explained in the 1902 case of \textit{Louisville & N.R. Co. v. McClain}.\textsuperscript{62}

In \textit{McClain}, the defendant moved the court to require the plaintiff to submit to a personal examination before trial. After this motion was overruled, the defendant, at trial, attempted to prove to the jury that the plaintiff had objected to the examination. The court sustained the plaintiff's objection to such proof and the defendant appealed.\textsuperscript{63}

The Code of Practice allows reversal of a lower court judgment only in the event of an error affecting the substantial rights of the complaining party. With this in mind, the court of appeals

\textsuperscript{57} Id.
\textsuperscript{58} 178 S.W.2d 185, 186 (Ky. Ct. App. 1944).
\textsuperscript{59} Id.
\textsuperscript{60} Id.
\textsuperscript{61} 44 S.W. at 91.
\textsuperscript{62} 66 S.W. 391 (Ky. Ct. App. 1902).
\textsuperscript{63} Id.
of Kentucky concluded, "It is discretionary with the [trial] court whether ... [it] will order a personal examination, and this court will not reverse unless there is an abuse of discretion, and it may fairly be concluded that the rights of the party complaining where substantially prejudiced."64 The court of appeals felt that there had been no abuse of discretion mainly because the testimony of all five doctors who had examined the plaintiff (either at the time of the accident or shortly thereafter) was in harmony.

There had been little conflict in the testimony of the five physicians at trial. There was also no room for doubt as to the extent of plaintiff's injuries. Accordingly, the appellate court reasoned, "[W]e are unable to see from the evidence that anything that was not shown by the evidence was before the jury."65 The plaintiff had a right to stand on what he conceived to be a "sufficient showing as to his injuries" to be submitted to the jury.66

Although the Kentucky cases just discussed make it explicitly clear that there is no absolute right to have an order for examination made under CR 35.01 and that such matters are determined in the sound discretion of the court, there are no cases which have actually ruled on whether a plaintiff can object to the defendant's "choice of physician."

*Keller & Brady Co. v. Berry*67 is the only Kentucky case remotely similar in analysis to *Gitto*. In *Keller*, the defendant proposed to have the plaintiff examined by two physicians the defendant had chosen as witnesses. The plaintiff declined to submit unless the court required him to do so.68 When the court offered to have an examination performed by an impartial physician, the defendant withdrew his motion for examination. On appeal, it was held that the court had complete discretion in such matters and that such examinations "should always be made by some impartial physician appointed by the court."69

*Keller* is different from the other Kentucky cases in that the issue presented was not whether there was a right to an exam-

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64. Id.
65. Id.
66. Id.
68. Id. at 1010.
69. Id.
ination but rather whether the doctors named by the defendant were to be automatically used by the court once it was determined that an examination was appropriate. The Keller court answered this in the negative, agreeing with the Gitto decision that there is no absolute right to choice of physician.

The authors of Kentucky Practice would also agree with this analysis. They commented that the view that there is "no absolute right to the choice of a physician" has become axiomatic.\(^7\)\(^0\)

A party under certain circumstances may object to a particular physician performing the examination, although there is no objection to submitting to an examination. In this case, a motion should be filed requesting the appointment of an impartial medical expert. Although the practice generally followed is not to object to the physician selected by the moving party, the Rule does not so require. A party refusing to submit to an examination by the medical expert chosen by the opposing party should be prepared to offer cogent reasons for his objections. General objection to the physician chosen is insufficient.\(^7\)\(^1\)

III. CONCLUSION

The most common area of litigation in which Rule 35 controversies arise is in negligence actions. In the usual scenario, the plaintiff is seeking damages for personal injuries and the defendant wants a medical examination done by a physician of his choice. The defendant moves the court under Rule 35 to order a physical or mental examination. In general, the plaintiff should only object in the extreme cases where the defense has chosen an obviously biased doctor to perform the examination.\(^7\)\(^2\) Such "doctors for hire" are usually well known throughout the legal profession because of their notorious reputation for consistently rendering medical evaluations favorable to the party hiring them.

Many practitioners express the view that objecting to the defendant's choice of physician is unwise because an unfavorable opinion by the "judge's independent doctor" tends to have more weight and is therefore more damaging to the plaintiff's case than the same opinion from the defendant's "hired gun."\(^7\)\(^3\) The

\(^7\)\(^0\) BERTELSMAN, supra note 6, at 644.
\(^7\)\(^1\) Id. at 644-45.
\(^7\)\(^2\) Tip of the Month, supra note 29.
\(^7\)\(^3\) Id.
general consensus seems to be that a doctor-for-hire’s credibility can be effectively attacked on cross-examination. However, there are certain situations in which a biased doctor’s evaluation can do irreparable harm to the plaintiff’s case. Therefore, “use the objection sparingly, but don’t be afraid to use it in the right case.”

To conclude, the following points should be considered in all cases involving Rule 35: (1) Notice of a motion under CR 35.01 must be given to the person to be examined and all other parties to the action. Once the court enters an order, it shall specify the time, place, manner, conditions, scope of the examination, and the physician or physicians by whom the examination is to be made. (2) The court may also select a physician other than the one suggested by the moving party, and failure to obey the court’s order in this regard can result in sanctions under the provisions of Rule 37.02. (3) One commentator has recommended that counsel try to be present with his client when the examining physician takes the patient’s history, and to note the time taken to perform any tests as well as the type of tests administered. (4) The same article also notes, “If counsel for the examinee has prior harmful reports that have not been discovered by the party requesting and conducting the examination, good strategy may dictate that he not request a report from the examining physician.” (5) Finally, “Any time counsel deals with a physician he should refresh his recollection as to the applicability of the Interprofessional Code for Physicians and Attorneys. This code provides guidelines for ‘professional courtesy’ relating to discovery from physicians.”

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74. Id.
75. BERTELSMAN, supra note 6, at 644.
76. Id.
78. Id.