

William & Mary Law Review

Volume 19 (1977-1978)
Issue 3

Article 5

March 1978

Carrybacks and the (F) Reorganization

Follow this and additional works at: <https://scholarship.law.wm.edu/wmlr>



Part of the [Tax Law Commons](#)

Repository Citation

Carrybacks and the (F) Reorganization, 19 Wm. & Mary L. Rev. 555 (1978),
<https://scholarship.law.wm.edu/wmlr/vol19/iss3/5>

Copyright c 1978 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.

<https://scholarship.law.wm.edu/wmlr>

CARRYBACKS AND THE (F) REORGANIZATION

Corporations may reorganize without the tax consequences of a sale or exchange by conforming to any one of the six types of nontaxable reorganizations defined in section 368(a)(1) of the Internal Revenue Code.¹ If the new corporation incurs losses after the reorganization, it will desire the tax benefit of a refund by carrying back the losses to pre-reorganization income.² Such a refund is available to a corporation that existed prior to the reorganization; however, if an entirely new entity was formed in the reorganization, it may not carry back its losses to the transferor corporation's income unless the reorganization complied with section 368(a)(1)(F).³ This exemption, created for (F) reorganizations, requires that the new corporation be essentially the same entity, having undergone "a mere change in identity, form, or place of organization, however effected."⁴

1. I.R.C. § 368(a)(1)(A)-(F). The six nontaxable reorganizations include: (A) reorganizations, statutory mergers and consolidations; the (B) reorganization, acquisition of the stock of one corporation by another; the (C) reorganization, acquisition of the assets of one corporation by another; the (D) reorganization, transfer of substantially all the assets from one corporation to another; (E) reorganizations, recapitalizations; and (F) reorganizations, changes in identity, form, or place of organization. *Id.*

2. I.R.C. § 172, which governs the net operating loss carryback, provides in part: "There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year." *Id.* § 172(a). Section 172 also provides that "a net operating loss for any taxable year ending after December 31, 1957, shall be a net operating loss carryback to each of the 3 taxable years preceding the taxable year of such loss," *id.* § 172(b)(1)(A)(i), and it defines the net operating loss as "the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modifications specified in subsection (d)." *Id.* § 172(c). Corporations must modify their net operating loss to account for dividends received, partially exempt interest under *id.* § 242, or income relating to Western Hemisphere trade corporations under *id.* § 922. *Id.* § 172(d)(5)-(6).

3. *Id.* § 381(b). Section 381(b) provides in pertinent part:

Operating Rules. — Except in the case of an acquisition in connection with a reorganization described in subparagraph (F) of section 368(a)(1)—

....
....

(3) The corporation acquiring property in a distribution or transfer described in subsection (a) shall not be entitled to carry back a net operating loss or a net capital loss for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor or transferor corporation.

Loss carrybacks may be applied to all income except that of a transferor corporation no longer in existence after the reorganization. No restriction exists on loss carrybacks to the pre-reorganization income of an acquiring corporation that survives the reorganization. *Id.* § 381(b)(3).

4. *Id.* § 368(a)(1)(F).

Exactly what constitutes an (F) reorganization currently is unclear. In 1966, the Internal Revenue Service (IRS) argued successfully for the expansion of a previously narrow definition to prevent certain tax abuses,⁵ but the IRS now strongly opposes the application of this expanded definition in situations concerning corporations' eligibility for loss carrybacks. Consequently, the IRS,⁶ the Tax Court,⁷ several courts of appeals,⁸ and the Court of Claims⁹ are in apparent conflict as to the nature of the (F) reorganization and its application to loss carrybacks.

This Note will outline the history and recent expansion of the (F) reorganization. It will describe the effect of this expansion in situations involving loss carrybacks, focusing on the economic reality of (F) reorganizations and the congressional intent as to loss carrybacks. This Note also will identify the conflicting treatments of (F) reorganizations resulting from this recent expansion and will attempt to reconcile these divergent viewpoints in a manner consistent with the expansive trends.

(F) REORGANIZATIONS

Background

Introduced in 1921,¹⁰ the (F) reorganization's purpose was to char-

5. *Reef Corp. v. Commissioner*, 368 F.2d 125 (5th Cir. 1966); *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967).

6. Rev. Rul. 75-561, 1975-2 C.B. 129.

7. *Romy Hammes, Inc. v. Commissioner*, 68 T.C. 900 (1977) (carryback not allowed to the income of one of several pre-merger corporations because lack of absolute continuity of shareholder interest prevented transaction's characterization as an (F) reorganization and because the particular pre-merger corporation not engaged in business venture creating loss); *Berger Mach. Prod., Inc. v. Commissioner*, 68 T.C. 358 (1977) (merger of four operating corporations not an (F) reorganization when continuity of shareholder interest not absolute).

8. *Home Constr. Corp. of America v. United States*, 439 F.2d 1165 (5th Cir. 1971) (merger of 123 functionally related and commonly owned corporations an (F) reorganization); *Estate of Stauffer v. Commissioner*, 403 F.2d 611 (9th Cir. 1968) (merger of three corporations owned by one shareholder into corporate shell both an (F) and an (A) reorganization); *Associated Mach. v. Commissioner*, 403 F.2d 622 (9th Cir. 1968) (merger of two corporations an (F) reorganization).

9. *Movielab, Inc. v. United States*, 494 F.2d 693 (Ct. Cl. 1974) (merger of wholly owned subsidiary into parent corporation an (F) reorganization).

10. Int. Rev. Code of 1921, ch. 2, § 202(c)(2), 42 Stat. 230 (now I.R.C. § 368(a)(1)(F)). Section 202 originally defined an (F) reorganization as a "mere change in identity, form or place of organization of a corporation (however effected)." *Id.* In 1924 Congress eliminated the words "of a corporation" but explained this alteration as a change only in wording. H.R. REP. NO. 179, 68th Cong., 1st Sess. 13 (1924). Despite numerous re-enactments of the provision, Congress never elaborated on the ultimate limits of the definition.

acterize as one continuing entity a corporation that moved its domicile by reincorporating in another state or that made some other formal changes.¹¹ The initial narrow breadth of the (F) reorganization created little controversy,¹² in that the provision applied only to formal corporate changes that did not alter the entity's status as a taxpayer.¹³ Reflecting the statute's limited application, the Supreme Court in 1942 determined that an (F) reorganization must have resulted in no shift of corporate ownership in *Helvering v. Southwest Consolidated Corp.*¹⁴ In that decision, the Court rejected summarily an alternative argument that an insolvency reorganization under which the secured creditors of a corporation succeeded to majority control constituted an (F) reorganization, stating: "a transaction which shifts the ownership of the proprietary interest in a corporation is hardly 'a mere change in identity, form, or place of organization'. . . ."¹⁵

11. (F) reorganizations are characterized by mere formalistic changes that result in no shift in ownership. See S. REP. NO. 2090, 85th Cong., 2d Sess. 61, reprinted in [1958] U.S. CODE CONG. & AD. NEWS 4454, which discussed the exemption from a stamp tax of stock delivered pursuant to an (F) reorganization. Int. Rev. Code of 1954, ch. 34, § 4382(b)(1)(D), 72 Stat. 1302 (repealed 1977). Although the Senate report did not mention expressly (F) reorganizations, its definition of a qualifying reorganization was identical to the Code's definition of that type. Therefore, the explanation is applicable to (F) reorganizations. See *Columbia Gas, Inc. v. United States*, 366 F.2d 991 (Ct. Cl. 1966).

The Supreme Court's decision in *Marr v. United States*, 268 U.S. 536 (1926), decided under the 1913 Internal Revenue Code, illustrates the need for the (F) reorganization. After General Motors had moved its domicile from New Jersey to Delaware, the government taxed a shareholder on purported gain. The Court held that the reincorporation produced a new entity because Delaware's corporation law provided different rights and duties than did the law in New Jersey. *Id.* at 541. Furthermore, in focusing on Code provisions that make no reference to § 368, courts have not treated as the same entity a corporation that has changed its place of incorporation. See, e.g., *Jefferson Lake Sulphur Co. v. United States*, 195 F.2d 1012 (5th Cir.), cert. denied, 344 U.S. 818 (1952); *American Gas Mach. Co. v. Willcuts*, 84 F.2d 925 (7th Cir. 1936).

12. See H.R. REP. NO. 350, 67th Cong., 1st Sess. 10 (1921). See generally Rev. Rul. 64-250, 1964-2 C.B. 333; Rev. Rul. 54-269, 1954-2 C.B. 114.

13. The tax year of a corporation formed in any type of reorganization, except the (F) type, ends on the day the reorganization is completed. I.R.C. § 381(b)(1)-(2). In contrast, the Regulations state that the corporation formed in an (F) reorganization must be treated as if no reorganization has occurred. Treas. Reg. § 1.381(b)-1 (1960). Similarly, the small business loss provision mandates that the corporation created in an (F) reorganization be treated in the same manner as was its predecessor. I.R.C. § 1244(d). In accordance with this treatment, Congress has provided that the successor corporation in an (F) reorganization, unlike those formed in other types, may carry back its operating losses to its pre-reorganization income. *Id.* § 381(b)(3). For the text of § 381(b)(3), see note 3 *supra*.

14. 315 U.S. 194, 203 (1942).

15. *Id.*

In the 1960's, the IRS began invoking the (F) reorganization provision to prevent taxpayers from using formalistic sale and liquidation transactions to convert ordinary income into capital gains. Although these transactions were accomplished through a variety of methods, they essentially involved the transfer of a business, without its accumulated earnings, to a second corporation, which then continued operations. The old corporation subsequently liquidated, distributing its accumulated earnings to the shareholders at capital gain rates. The IRS maintained that the first corporation had not been liquidated but, instead, had undergone "a mere change in identity, form, or place of organization," that is, an (F) reorganization.¹⁶ Consequently, because the proceeds from the old corporation's purported liquidation were paid from earnings, argued the IRS, they were dividends taxable at ordinary income rates rather than distributions of capital upon liquidation taxable at capital gain rates.¹⁷

In 1966, the Court of Appeals for the Fifth Circuit accepted the IRS's position in *Davant v. Commissioner*¹⁸ and *Reef Corp. v. Commissioner*.¹⁹ The results of these cases, however, introduced two new dimensions to the concept of the (F) reorganization. In *Davant* the court determined that the merger of two operating companies constituted an (F) reorganization,²⁰ and in *Reef Corp.* it characterized a transaction that involved a substantial shift in ownership interests resulting from the redemption of all the stock of some shareholders as an (F) reorganization.²¹ Other courts subsequently applied this expanded concept of the (F) reorganization in factual situations different from those presented in *Davant* and *Reef Corp.*, particularly to permit the carryback of post-reorganization losses to pre-reorganization income.²²

16. See, e.g., *Reef Corp. v. Commissioner*, 368 F.2d 125 (5th Cir. 1966); *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967); Rev. Rul. 61-156, 1961-2 C.B. 62.

17. Dividend distributions, to the extent of the corporation's earnings, are taxed as ordinary income. I.R.C. §§ 301, 316. Taxed more favorably, proceeds from a corporation's liquidation or from a stock redemption are regarded first as a return of capital and then as capital gain. *Id.* §§ 302, 331.

18. 366 F.2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967).

19. 368 F.2d 125 (5th Cir. 1966).

20. 366 F.2d at 884.

21. 368 F.2d at 134-37.

22. See *Aetna Cas. & Sur. Co. v. United States*, 77-1 U.S.T.C. ¶ 9120 (2d Cir. 1976); *Home Constr. Corp. of America v. United States*, 439 F.2d 1165 (5th Cir. 1971); *Associated Mach.*

Merger of Operating Corporations

In *Davant* one corporation sold its operating assets for cash to a second operating corporation. The shareholders owned identical percentage interests in each entity. After the sale, the transferor corporation was liquidated, and both its retained earnings and the cash received on the sale of the business were distributed to its shareholders.²³ Under a technical interpretation of the Code, this transaction enabled the stockholders to receive both corporations' accumulated earnings at capital gain rates, while permitting the business to continue uninterrupted.²⁴ The IRS, however, argued that these actions functionally constituted an (F) reorganization rather than a bona fide sale and liquidation.²⁵

The Fifth Circuit upheld the IRS's position, finding that the transaction was an (F) reorganization and, therefore, that a dividend had been paid to the extent of both corporations' earnings and profits.²⁶ The court noted that, although the transaction conceptually satisfied the requirements of a sale and liquidation, it lacked a business purpose.²⁷ Moreover, even though the acquiring corporation possessed its own assets, the transaction had effected changes only in the form, rather than in the substance, of the two corporations.²⁸ Finally, the court held that the "liquidation" distributions actually were dividends paid simultaneously with, but functionally

v. Commissioner, 403 F.2d 622 (9th Cir. 1968); *Estate of Stauffer v. Commissioner*, 403 F.2d 611 (9th Cir. 1968); *Performance Syss., Inc. v. United States*, 382 F. Supp. 525 (M.D. Tenn. 1973), *aff'd per curiam*, 501 F.2d 1338 (6th Cir. 1974); *Movielab, Inc. v. United States*, 494 F.2d 693 (Ct. Cl. 1974).

23. Because the transaction maintained a continuity of the stockholder's interests in both the acquiring and the transferor corporations, it might have been characterized as a (D) reorganization. See note 1 *supra*. To avoid such a classification, an "unrelated party," the son of the lawyer who planned the sale and liquidation, purchased the transferor corporation's stock and completed the transaction, thus receiving the liquidation proceeds. The lawyer's son used these proceeds to pay the original shareholders his "purchase" price of their stock, retaining a profit for his efforts. The original owners claimed that they recognized capital gains on the sale of their stock. 366 F.2d at 878-79.

24. *Id.* See note 23 *supra*.

25. 366 F.2d at 879. Agreeing with one of the IRS's alternative theories, the Tax Court disregarded the purported sale to the attorney's son and found that the transaction was a (D) reorganization. *Id.* at 883. See note 23 *supra*. Consequently, it concluded that the distributions were dividends, which were taxable as ordinary income to the extent of the transferor corporation's earnings. 366 F.2d at 883.

26. *Id.* at 887-89.

27. *Id.* at 882.

28. *Id.* at 884.

unrelated to, the reorganization.²⁹

In its characterization of the transaction in *Davant* as an (F) reorganization and an unrelated dividend distribution, the Fifth Circuit prevented the taxpayers from receiving unwarranted capital gains in lieu of ordinary income. The court's expanded concept of (F) reorganizations, however, could be applicable in situations involving similar mergers of two or more operating corporations that were unaccompanied by any dividend payments. Taxpayers would desire such an expanded application in circumstances presenting the possibility of loss carrybacks, because section 381(b)(3) prohibits an acquiring corporation from carrying back its post-reorganization losses to the pre-reorganization income of the transferor corporation unless the reorganization was an (F) type.³⁰ By enlarging the definition of (F) reorganizations to include the merger of two operating corporations, the decision in *Davant* thus increases the availability of post-reorganization loss carrybacks to pre-reorganization income.³¹

The IRS initially opposed the application of *Davant* to allow post-reorganization loss carrybacks after a merger of two operating corporations, and the Tax Court supported this position.³² Nevertheless, the Courts of Appeals for the Fifth,³³ Sixth,³⁴ and Ninth Circuits,³⁵ as well as the Court of Claims,³⁶ have applied *Davant's* expanded concept of the (F) reorganization in situations involving loss carrybacks, and the IRS now has accepted the proposition.³⁷ Subjecting the availability of this concession to a strict continuity of interest test, however, the IRS requires that both the shareholders and their percentage interests in the corporation be identical before and after the reorganization.³⁸

29. *Id.* at 888.

30. I.R.C. § 381(b)(3). For text of § 381(b)(3), see note 3 *supra*.

31. See text accompanying note 22 *supra*.

32. See, e.g., *Romy Hammes, Inc. v. Commissioner*, 68 T.C. 900 (1977); *Berger Mach. Prod., Inc. v. Commissioner*, 68 T.C. 358 (1977); *Estate of Stauffer v. Commissioner*, 48 T.C. 277 (1967), *rev'd*, 403 F.2d 611 (9th Cir. 1968); *Associated Mach. v. Commissioner*, 48 T.C. 318 (1967), *rev'd*, 403 F.2d 622 (9th Cir. 1968).

33. See, e.g., *Home Constr. Corp. of America v. United States*, 439 F.2d 1165 (5th Cir. 1971).

34. See, e.g., *Performance Syss., Inc. v. United States*, 382 F. Supp. 525 (M.D. Tenn. 1973), *aff'd per curiam*, 501 F.2d 1338 (6th Cir. 1974).

35. See, e.g., *Associated Mach. v. Commissioner*, 403 F.2d 622 (9th Cir. 1968); *Estate of Stauffer v. Commissioner*, 403 F.2d 611 (9th Cir. 1968).

36. *Movielab, Inc. v. United States*, 494 F.2d 693 (Ct. Cl. 1974).

37. Rev. Rul. 75-561, 1975-2 C.B. 129.

38. *Id.* The Revenue Ruling prescribes three requirements: complete identity of sharehold-

Unrelated Redemption

The Fifth Circuit's decision in *Reef Corp.* provides a means for attacking the IRS's reliance on the continuity of shareholder interest test to limit the application of the (F) reorganization concept in loss carryback situations. Decided soon after *Davant*, *Reef Corp.* involved another attempt by stockholders to characterize dividends as capital gains through the device of a sale of the business to a newly organized corporation and a subsequent liquidation of the transferor corporation. The transaction, which included the redemption of forty-eight percent of the transferor corporation's stock, created a substantial change in the identity of the shareholder's interests.³⁹

Notwithstanding the stock redemption, the Fifth Circuit characterized the transaction as an (F) reorganization.⁴⁰ The court regarded the (F) reorganization and the stock redemption as functionally separate events;⁴¹ it noted that, with the exception of the redemption, the only other alterations, which consisted of changes in the corporation's name and its state of incorporation, were characteristics common to an (F) reorganization.⁴² Moreover, although the redemption was a feature of a reorganization, it nevertheless had

ers and their proprietary interests, operation of related businesses, and continuation of the businesses in the new form. *Id.*; see Cole & Brezak, *Meeting the IRS' New F Reorganization Tests; Requirements; Planning Potential*, 4 J. OF TAX. 344 (1976).

39. The transaction in *Reef Corp.* eliminated 48% of the stockholders' interest through a redemption of stock for cash and notes and also converted some of the remaining majority shareholders' stock into notes. Hoping to avoid an immediate tax on their receipt of the notes, the majority shareholders insisted that all the stock be sold to an "unrelated party," an attorney associated with the minority stockholders, for his personal notes. The attorney sold all the old corporation's assets to a new corporation that had been organized by the majority shareholders who, in exchange for some of their stock in the old corporation, received 100% of the new corporation's stock. In a subsequent liquidation of the old corporation, the attorney received the notes that the new corporation had exchanged for the old corporation's assets, and he pledged them as security for the personal notes he had given to the original shareholders. In effect, then, the new corporation paid for the attorney's stock purchases. Moreover, the majority stockholders, who had become the sole owners of the new corporation, chose to defer the taxes payable on their receipt of the attorney's notes by electing the installment method of reporting their gain. The new corporation also benefited because the assets it purchased from the old corporation received a stepped-up cost basis for purposes of determining depreciation deductions against ordinary income. The IRS challenged this transaction on the ground that the interest paid on the notes to the shareholders of the new corporation was a dividend and therefore nondeductible. 368 F.2d at 127-28.

40. *Id.* at 137.

41. *Id.* at 134.

42. *Id.* at 136.

no effect on the reorganization because the business continued unchanged except in form.⁴³

The decision in *Reef Corp.*, like that in *Davant*, potentially expanded the (F) reorganization's definition beyond the particular abuse presented in that case. The Fifth Circuit's holding that an (F) reorganization can be accompanied by a stock redemption creating a shift in the shareholders' percentage interests has been applied to characterize as an (F) reorganization corporate changes that do not conform with the IRS's strict continuity of interest requirement⁴⁴ and thus to permit loss carrybacks under section 381(b)(3).⁴⁵

In *Aetna Casualty & Surety Co. v. United States*⁴⁶ the Second Circuit applied the decision in *Reef Corp.* to allow such a loss carryback.⁴⁷ *Aetna* involved a transfer of a subsidiary corporation, sixty percent of which was owned by the parent, to the latter's shareholders and a simultaneous conversion of the subsidiary's forty percent minority interest into equal ownership shares in the parent and subsidiary corporations. Pursuant to this goal, the parent corporation exchanged some of its stock for all the stock of a new corporation, which had been organized for the sole purpose of acquiring the subsidiary corporation. In a merger this new corporation exchanged the parent's stock for that of the subsidiary and then cancelled the subsidiary's stock, assuming its business and continuing its operations as they had been conducted before the reorganization. Finally, for the benefit of its shareholders, the parent transferred to a trust its stock in the new corporation. As a result of the transaction, the forty percent minority interest in the subsidiary became a twenty percent interest in both the parent and the acquiring corporations. Despite the alteration in the stockholders' percentage ownership interests, however, the Second Circuit characterized these actions as an (F) reorganization and an unrelated redemption, thus permitting the new corporation to carry back its post-reorganization losses to the subsidiary's pre-reorganization income.⁴⁸

43. *Id.*

44. See note 38 *supra* & accompanying text.

45. See *Aetna Cas. & Sur. Co. v. United States*, 77-1 U.S.T.C. ¶ 9120 (2d Cir. 1976); cf. *Casco Prod. Corp. v. Commissioner*, 49 T.C. 32 (1967), *appeal dismissed*, No. 32261 (2d Cir. June 11, 1968) (carryback allowed because Tax Court held that corporate merger into a shell corporation in order to redeem nine percent minority interest not a reorganization).

46. 77-1 U.S.T.C. ¶ 9120 (2d Cir. 1976).

47. *Id.* at 86,092.

48. *Id.* at 86,091. *Aetna's* precedential value may be questioned inasmuch as the taxpayer

Both *Reef Corp.* and *Aetna* involved a substantial shift in shareholder percentage interest. Nevertheless, in both cases, the transferor corporation's business was continued unchanged by the acquiring corporation, control was not altered, and no new shareholders were introduced. Under these circumstances, when one corporation's operations are transferred to a newly created corporate shell, the Second and possibly the Fifth Circuits would reject the IRS's requirement that a strict continuity of shareholder interest accompany an (F) reorganization before the transferee corporation may carry back its losses to the transferor's pre-reorganization income.

CURRENT CONFLICT

The (F) reorganization's expanded definition has been applied in two types of unrelated situations involving loss carrybacks. The cases following the holding in *Reef Corp.* that a complete continuity of interest is not a requirement of an (F) reorganization have involved the merger of a single operating corporation into a newly formed corporate shell that lacked its own assets, business, and tax history.⁴⁹ The new corporation then has operated the old entity's business, offering the same products or services and retaining the same employees and essentially the same customers. The reorganized corporation, in effect, is the same entity, having altered only its identity. In contrast, the cases following the holding in *Davant* that the merger of two or more operating corporations can be an (F) reorganization all have involved a complete continuity of shareholder interest: neither the identity of the stockholders nor their percentage interests had been changed by the reorganization.⁵⁰

The current conflict has resulted from attempts to invoke the (F) reorganization provision when the merger of two or more operating corporations has not been accompanied by a complete continuity of shareholder interest. This hybrid situation, which combines certain factors previously unique to the cases following either *Reef Corp.* or *Davant*, may be illustrated by a hypothetical merger of two corporations of equivalent value that operate related businesses. Assume

had abandoned its (F) reorganization theory on appeal, and the IRS consequently had no opportunity to present its argument to the appellate court. Petition for Rehearing at 4, *Aetna Cas. & Sur. Co. v. United States*, 77-1 U.S.T.C. ¶ 9120 (1976), rehearing denied, 77-1 U.S.T.C. ¶ 9261 (1977).

49. See cases cited note 45 *supra*.

50. See cases cited notes 33-36 *supra*.

initially that A owns all the stock of one corporation and ninety percent of the second and that B accounts for the remaining ten percent ownership. After the merger, A will own ninety-five percent of the stock and B will own five percent. The question arises whether this merger is an (F) reorganization and whether the transferee corporation may carry back its post-merger losses to the transferor corporations' pre-merger income. Although no exact continuity of shareholder interest exists between the old and new corporations, the adjusted percentage interests in the new entity conform to the value of the stockholders' interests in the old corporations. Moreover, the old corporations' business continues without significant change; no substantial shift has occurred in corporate control, and no new stockholders have been introduced.

In 1977 in *Berger Machine Products, Inc. v. Commissioner*⁵¹ the Tax Court confronted an analogous factual situation. *Berger Machine* involved the merger into a single newly organized corporation of four corporations conducting related businesses. The transaction introduced no new shareholders. Five individuals owned the stock of the pre-merger corporations, and, although their relative control remained the same, their percentage interests were altered as a result of the merger. Following the merger, the new corporation suffered operating losses, which it attempted to carry back to the transferor corporations' pre-merger income.

The Tax Court disallowed the carryback.⁵² Adhering to its previous decisions, which the Ninth Circuit had reversed,⁵³ the court rejected the proposition that two or more operating corporations could merge in an (F) reorganization.⁵⁴ Moreover, the court adopted the IRS's requirement of complete continuity of shareholder interest as an essential condition of an (F) reorganization.⁵⁵

The dissent in *Berger Machine* argued that the need for consistency in the tax laws required the Tax Court to abandon its conservative position precluding operating corporations from merging in an (F) reorganization and to adopt the position of the other federal

51. 68 T.C. 358 (1977).

52. *Id.* at 365.

53. *Associated Mach. v. Commissioner*, 48 T.C. 318 (1967), *rev'd*, 403 F.2d 622 (9th Cir. 1968); *Estate of Stauffer v. Commissioner*, 48 T.C. 277 (1967), *rev'd*, 403 F.2d 611 (9th Cir. 1968).

54. 68 T.C. at 364.

55. *Id.* at 364-65.

courts.⁵⁶ According to the dissent, the decision in *Aetna* should have controlled the continuity of interest issue because the stockholders had maintained their individual proprietary interests and their relative abilities to exercise corporate control; only their numerical percentage interests had changed.⁵⁷

Additional similarities between *Berger Machine* and *Aetna* exist: neither case involved the introduction of new stockholders, and in both situations the businesses continued operations unaffected by the reorganization. The only substantial difference between the two cases is that *Berger Machine* involved a merger of several operating corporations whose individual business activities prior to the reorganization became divisions in the new corporation, whereas in *Aetna* a single entity's operations were transferred to a newly created corporate shell. A rejection of this distinction, however, and an application of *Aetna* to the facts in *Berger Machine*, as noted by the dissent in the latter case, would have required that the merger be characterized as an (F) reorganization and that the taxpayer be permitted to carry back its post-reorganization losses.⁵⁸ Nevertheless, the Tax Court not only declined to accept this position in *Berger Machine*, but it subsequently reaffirmed its narrow construction of the (F) reorganization provision in *Romy Hammes, Inc. v. Commissioner*.⁵⁹ The Second Circuit also has indicated that it may not apply its decision in *Aetna* to characterize the merger of operating corporations as an (F) reorganization.⁶⁰

Despite this initial judicial reluctance to extend *Aetna*'s and *Reef Corp.*'s holding to situations involving the merger of operating corporations, those cases could present courts with an opportunity for alleviating the potentially restrictive effect on taxpayers' use of the (F) reorganization provision created by the IRS's artificial continuity of shareholder interest requirement. An expanded application of those holdings would provide courts with flexibility in their evaluations of the merits of alleged (F) reorganizations. Under such an approach, mere shifts in shareholders' percentage interests would not necessarily jeopardize the characterization of a merger as an (F)

56. *Id.* at 365 (dissenting opinion).

57. *Id.* at 366.

58. *Id.*

59. 68 T.C. 900 (1977).

60. *Aetna Cas. & Sur. Co. v. United States*, 77-1 U.S.T.C. ¶ 9261, at 86,523 (2d Cir. 1977) (denying rehearing to 77-1 U.S.T.C. ¶ 9120 (1976)).

reorganization and thereby prevent the carrying back of corporate losses to pre-reorganization income. An analysis of the economic reality reflected in (F) reorganizations and of the congressional intent pertaining to loss carrybacks demonstrates the propriety of this result.

ECONOMIC REALITY: (F) REORGANIZATIONS

In applying the tax laws to the myriad of potential situations, courts often have ignored the form of a transaction and focused on its substance to levy taxes on the basis of economic reality rather than on formal considerations that are subject to manipulation.⁶¹ The emphasis on substance requires a determination of whether the particular transaction in issue is a sale or a reorganization, a question frequently resolved by ascertaining intent.⁶² If the parties intended to produce the results of a reorganization, the judiciary often holds accordingly, disregarding formalistic steps taken merely to minimize tax consequences. Thus, to reflect economic reality and to prevent tax abuse, courts have held transactions structured as sales or liquidations to be reorganizations.⁶³ Conversely, if the parties to a transaction intended to purchase corporate assets, the courts may conclude that a sale rather than a reorganization has occurred.⁶⁴ In such circumstances, the purchaser obtains an adjustment in the basis of the corporate assets that he does not receive in a reorganization.⁶⁵

The (F) reorganization is particularly susceptible to a substance over form analysis because its definition in the Code includes no specific requirements. Rather, it is a formal change, "however ef-

61. The Supreme Court mandated that the judiciary evaluate the substance of a transaction in *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945). The Court proscribed the manipulation of the incidence of taxation by actions having no realistic economic purpose other than the minimization of tax consequences. *Id.* at 334.

62. See cases cited note 64 *infra*.

63. *Bazley v. Commissioner*, 331 U.S. 737 (1947); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933); *Weiss v. Stearn*, 265 U.S. 242 (1924); *Liddon v. Commissioner*, 230 F.2d 304 (6th Cir. 1956).

64. For example, the purchase of corporate stock for the purpose of acquiring corporate assets has been characterized as a sale rather than as a reorganization. See, e.g., *South Bay Corp. v. Commissioner*, 345 F.2d 698 (2d Cir. 1965); *Yoc Heating Corp. v. Commissioner*, 61 T.C. 168 (1973); *Estate of Suter v. Commissioner*, 29 T.C. 244 (1957).

65. In the event of a sale, the purchaser receives a new cost basis in the assets of the business. I.R.C. § 1012. In a reorganization, however, both the shareholders' stock and the corporate assets retain their pre-reorganization basis. *Id.* §§ 358, 362.

fected.”⁶⁶ Thus, the Fifth Circuit characterized the transaction in *Davant*, although formally structured as a sale, as an (F) reorganization because it resulted in a mere change in corporate identity.⁶⁷

The (F) reorganization differs conceptually from other reorganizations in that it cannot include any aspects of an exchange.⁶⁸ For example, an (A) reorganization, a statutory merger of two or more corporations,⁶⁹ may involve the combination of separately owned entities, the shareholders of which exchange their stock in the transferor corporations for stock in the acquiring corporation. If the same stockholders owned all the transferor corporations, however, the reorganization also could qualify and would be treated as an (F) reorganization.⁷⁰ In an (F) reorganization, then, the post-reorganization corporation must be essentially the same entity as the pre-reorganization corporation or corporations.⁷¹

Certain factors have been articulated as descriptive of (F) reorganizations. Among the most crucial is that, following the merger, the business operations continue in essentially the same form as they had existed before the reorganization.⁷² Another important consideration is that the transaction creating an (F) reorganization be structured to avoid the characteristics of a sale and to maintain stockholder interests. A transaction that introduces new shareholders, who presumably obtained their ownership interests in exchange for some consideration, creates more than a formal corporate change and therefore does not qualify as an (F) reorganization. In contrast, a percentage shift in the present shareholders' interests does not necessarily create such an economic change that the corporation's identity is altered, particularly if the shift does not affect corporate control.

The decisions in *Reef Corp.* and *Aetna*, in which the courts characterized the disputed transactions as (F) reorganizations despite shifts in the shareholders' percentage interests, involved mergers of single corporations into newly organized corporate shells. As demon-

66. *Id.* § 368(a)(1)(F).

67. 366 F.2d at 884.

68. *See, e.g., Helvering v. Southwest Consol. Corp.*, 315 U.S. 194, 203 (1942).

69. I.R.C. § 368(a)(1)(A).

70. *See, e.g., Griswold v. Commissioner*, 400 F.2d 427 (5th Cir. 1968); Rev. Rul. 57-276, 1957-1 C.B. 126. *See also Estate of Stauffer v. Commissioner*, 403 F.2d 611 (9th Cir. 1968).

71. *See note 4 supra* & accompanying text.

72. *See, e.g., Home Constr. Corp. of America v. United States*, 439 F.2d 1165, 1172 (5th Cir. 1971).

strated in *Davant* and its progeny, however, the (F) reorganization provision is sufficiently flexible to encompass the merger of two or more operating corporations, at least when the businesses of the pre-merger corporations are integrated in their operations. Such a merger should not be denied the status of an (F) reorganization merely because it creates a shift in the shareholders' percentage interests. Rather, as with the single corporation reorganizations in *Aetna* and *Reef Corp.*, the relevant inquiry in a situation involving the merger of two or more operating corporations should be whether the transaction created more than formal corporate changes. Provided that the merger has not upset the continuity of business operations, has introduced no new stockholders, and has not altered corporate control, it should be classified as an (F) reorganization. Consequently, the IRS's invocation of an absolute continuity of shareholder interest requirement as a prerequisite for a valid (F) reorganization involving two or more operating corporations conflicts with the requirement that the judiciary evaluate the entire substance of such transactions.

CONGRESSIONAL INTENT: CARRYBACKS

Initially, loss carryovers—both carrybacks to prior years and carryovers to subsequent years—served to provide tax equity by permitting businesses to report fluctuating income patterns exceeding the length of a single taxable year.⁷³ To achieve this goal, Congress adopted an averaging technique involving the carryback and carryover of losses to years in which businesses had taxable income.⁷⁴ By providing that the ultimate tax levied on a corporation would be consistent with its income over a particular business cycle, the formula prevents the imposition of a tax on capital immediately after the business begins to recover its loss of operating cash.⁷⁵

73. Without the loss carryover provisions, taxpayers would be required to pay taxes on their annual receipts from a particular contract that extended several years, although they ultimately suffered a loss on the transaction as a whole. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931).

74. S. REP. NO. 1631, 77th Cong., 2d Sess. 122-23 (1942), reprinted in 1 J. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME AND EXCESS PROFITS TAX LAWS 1953-1939, at 1907-08 (1954). Throughout World War II, many businesses had been forced to postpone disbursements for what normally constitute regular expenses and therefore had been paying taxes on artificial income. Congress was concerned with the effect that the war's end would have on these businesses. *Id.*

75. *Id.*

Loss carrybacks also provide a business with cash when it is needed most, at the time of the loss. In its consideration of the interaction between carrybacks and reorganizations, Congress acknowledged the practical problems confronted by a corporation in its attempt to cope with financial setbacks.⁷⁶ Congress also demonstrated its awareness of the need for immediate cash generally created by business losses when it required that the IRS either reject or give a refund within ninety days of the taxpayer's filing of a claim for a tentative carryback adjustment.⁷⁷ Consequently, the purpose of the carryback provision has expanded: rather than merely permitting income averaging to account for fluctuations in the business cycle, it also assists businesses encountering financial difficulties by providing them with immediate refunds. An application of the carryback provision to all reasonably qualifying situations that are free from attempted statutory abuses⁷⁸ would best effectuate this expansive purpose.

Before 1954, no statutory rules governed the interaction between the carryback and reorganization provisions. Rather, inconsistent judicial interpretations based on technicalities filled the void.⁷⁹ As a result, loss corporations were sold not for the value of their business assets but for the tax value of their loss carryovers, as parties invoked the letter of the law in attempts to circumvent its policy of preventing one taxpayer from taking the deductions of another.⁸⁰

76. The Internal Revenue Code of 1954, as initially proposed, lacked a provision permitting the carryback of losses in situations involving (F) reorganizations. Congress added such a provision, I.R.C. § 381(b), after a congressional hearing, in which testimony was given concerning a New York firm that had changed its state of incorporation to New Jersey after many years of profitable operation. The firm suffered unexpected losses and was forced into bankruptcy when the Commissioner ruled that it was a different corporation and therefore not entitled to carry back its losses to the income it earned while domiciled in New York. Pugh, *The F Reorganization: Reveille for a Sleeping Giant?*, 24 TAX. L. REV. 437 (1969).

77. See I.R.C. § 6411(b). Before the IRS makes any refund it will credit the tax decrease resulting from the carryback toward any tax due from the corporation. *Id.*

78. An abusive application of the carryback provision would occur if a carryback that would not be allowed in the absence of a reorganization was permitted after the reorganization. See *Libson Shops, Inc. v. Koehler*, 353 U.S. 382, 388 (1957); Note, *Taxation—Net Operating Loss Carryovers—The Doctrine of Libson Shops & the Single Corporation Cases*, 14 WAYNE L. REV. 702 (1968). But see McGaffey, *Utilization of Net Operating Losses*, 51 TAXES 613 (1973), who suggests that, because the purchase price would reflect the ability of a buyer to use the net operating loss, the shareholders who sell a loss corporation would receive the benefit of the carryover. *Id.* at 620.

79. See H.R. REP. NO. 1337, 83d Cong., 2d Sess. 41 (1954). See also Grainger, *The New Internal Revenue Code: Carry-over & Carry-back of Losses After Corporate Mergers—Dividends-in-Kind of Appreciated Property*, 43 GEO. L.J. 208 (1955).

80. See, e.g., *New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1935).

In 1954, however, Congress added section 381 to the Code.⁸¹ Clarifying the law and formulating a rule for the use of carrybacks based "upon economic realities rather than upon such artificialities as legal form of reorganization,"⁸² section 381(b) governs the ability of reorganized corporations to take advantage of the Code's carryback provisions.⁸³ Consistent with the objective that only those taxpayers who actually suffered losses receive the benefits of carrybacks, the section permits only the acquiring corporation in an (F) reorganization to carry back a loss to the transferor corporation's pre-reorganization income.⁸⁴ Because an (F) reorganization comprises only formal changes, the acquiring corporation is the same taxpayer as the transferor entity.

By authorizing carrybacks after an (F) reorganization, Congress provides a tax benefit to the transferor corporation's shareholders who indirectly have paid the excessive pre-reorganization taxes through their receipt of decreased dividends and who also have suffered the post-reorganization loss through their receipt of diminished returns and a reduced value in their investment.⁸⁵ The denial of a carryback will prevent these stockholders from receiving an immediate tax benefit, despite their obvious injuries caused by the corporation's loss and the transferor corporation's payment of excessive taxes. Rather, they may never receive a tax benefit to offset their injuries, unless the corporation recovers from its loss and earns future taxable income to which it may apply a loss carryover deduction.⁸⁶

A reorganization that adds new shareholders does not qualify as an (F) type,⁸⁷ and the resulting corporation may not carry back its losses to the transferor corporation's pre-reorganization income. Such a result appropriately prevents an immediate tax benefit from accruing to the new shareholders who were unaffected by the trans-

81. I.R.C. § 381.

82. S. REP. No. 1622, 83d Cong., 2d Sess. 3, reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4629, 4683.

83. I.R.C. § 381(b). See note 3 *supra* & accompanying text.

84. I.R.C. § 381(b)(3). For the pertinent text of § 381(b), see note 3 *supra*.

85. See *Newmarket Mfg. Co. v. United States*, 233 F.2d 493, 493 (1st Cir. 1956).

86. A taxpayer that cannot carry back a net operating loss may carry the loss over to later taxable years in which it has taxable income. I.R.C. § 172(b)(1)(B), (2). Generally, pre-1976 losses must be used within the five taxable years following the loss year, and post-1975 losses must be used within seven years. I.R.C. § 172(b)(1)(B).

87. See, e.g., *Aetna Cas. & Sur. Co. v. United States*, 77-1 U.S.T.C. ¶ 9120, at 86,093 (2d Cir. 1976).

feror corporation's payment of its pre-reorganization taxes. The mere elimination of some stockholders in a reorganization, however, should produce a different result, particularly when the transaction has not altered corporate control. The remaining owners possess the attributes of those shareholders for whom Congress provided a tax benefit in its authorization of carrybacks by corporations formed in (F) reorganizations: they not only indirectly have paid the taxes of the pre-merger corporation, but they also have suffered the consequences of the post-reorganization loss. A change in their percentage ownership interests, therefore, should not prevent these continuing shareholders from receiving the benefits accompanying a carryback.

In *Aetna* the Second Circuit applied similar reasoning to permit a carryback when a shift in shareholder interest had occurred in an (F) reorganization involving a single operating corporation.⁸⁸ This reasoning likewise should apply when some changes in percentage ownership result from the merger of two or more operating corporations, assuming that a substantive evaluation denotes the entire transaction as an (F) reorganization. Absent a substantial shift in shareholder control more akin to a sale or exchange than to a reorganization, the failure to characterize such a situation as an (F) reorganization and a consequent disallowance of the carryback would deny a tax benefit that Congress created for the reorganized corporation and its shareholders.

A countervailing policy providing for the limitation of potential tax abuses could not ameliorate a misapplication of the carryback provisions. Rather, an inherent facet of the carryback is its lack of manipulative possibilities in situations involving corporate reorganizations. A post-reorganization loss, the event that creates the possibility of a carryback, generally is unexpected at the time of the transaction's planning and probably is not taken into account. Indeed, many reorganizations in which the new corporation has been prevented from carrying back its losses to pre-reorganization income easily could have been restructured in form so as to preserve at least part of the carryback without altering the substance of the reorganization. For example, in *Berger Machine*, if the four corporations had merged into one of the existing entities instead of into a newly created one, the survivor could have carried the loss back to its own pre-reorganization income.⁸⁹ To change its name or state of incorpo-

88. *See id.*

89. *See* note 3 *supra* & accompanying text.

ration the surviving corporation then could have merged into a corporate shell, without endangering its carryback privilege.⁹⁰

The strict allocation requirements imposed on the carryback of post-merger losses to pre-merger income after an (F) reorganization involving the merger of operating corporations also limits the potential for abusing the Code's carryback provisions. A qualifying loss must be attributable to the business operations conducted by one of the corporations existing before the reorganization, and the loss may be carried back only to offset that particular corporation's income.⁹¹ Moreover, as a condition to carrying back a net operating loss to pre-reorganization income, the taxpayer must bear the burden of establishing this relationship.⁹² Clearly, the minimal opportunity for abusing the carryback provisions in reorganization situations provides little support for the IRS's conclusion that a valid (F) reorganization must adhere strictly to a technical continuity of shareholder interest requirement.

CONCLUSION

Through the application of its absolute continuity of shareholder interest test, the IRS fails to characterize as (F) reorganizations certain transactions that leave unaltered both business operations and corporate control and that introduce no new stockholders. Consequently, the IRS prevents the availability of tax benefits, such as the averaging of business income over several years or the timely infusion of cash refunds in the event of a net operating loss, in some of the circumstances that they should be accorded. Although the IRS's test properly focuses on the corporate shareholders, who ultimately will receive the benefits of any carryback, it creates an overly rigid requirement of absolute continuity that could impede a substantive evaluation of a potential (F) reorganization.

Judicial resolution of the disagreement as to the degree of continuity of interest required for an (F) reorganization appears unlikely. By refining the definition of the (F) reorganization in an amendment to the Internal Revenue Code, Congress can provide the most appropriate clarification of the problem. In accordance with both

90. See note 11 *supra* & accompanying text. For a discussion of *Berger Machine*, see text accompanying notes 51-60 *supra*.

91. *Home Constr. Corp. of America v. United States*, 439 F.2d 1165, 1172 (5th Cir. 1971); Rev. Rul. 75-561, 1975-2 C.B. 129. See also *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957).

92. 439 F.2d at 1172.

the substantive characteristics of an (F) reorganization and the purpose of carrybacks, such an amendment should codify the continuity of interest test articulated in *Aetna* and allow its application to the merger of operating corporations.

COMMENTS

GAGLIARDI v. FLINT: THE JOINDER OF CONSTITUTIONAL AND PENDENT STATE CLAIMS AGAINST A MUNICIPAL CORPORATION IN A FEDERAL FORUM

Municipal governments' assumption of greater responsibility for societal functions increasingly exposes citizens to the infliction of legal injury by public employees.¹ Relief for such injuries ostensibly is offered by the Civil Rights Act of 1871,² which was enacted to provide redress for actions by state and local officials violating established constitutional and statutory rights.³ The Act's broadest provision, codified as section 1983, awards damages and equitable relief for invasion of such rights by persons acting under color of state law or custom.⁴

A citizen asserting a section 1983 claim may desire to maximize

1. See Sherry, *The Myth That the King Can Do No Wrong: A Comparative Study of the Sovereign Immunity Doctrine in the United States and New York Court of Claims*, 22 *AN. L. REV.* 39, 58 (1969). Municipal involvement ranges from the provision of public services such as education, housing, and fire and police protection to the regulation of business activity through the licensing of such activities as housing construction and the sale of alcoholic beverages.

2. Civil Rights Act, ch. 22, § 1, 17 Stat. 13 (1871) (current version at 28 U.S.C. § 1343 (1970) and 42 U.S.C. § 1983 (1970)).

3. See *Monroe v. Pape*, 365 U.S. 167, 175-76 (1961) (citing *CONG. GLOBE*, 42d Cong., 1st Sess. 653 (1871)).

4. 42 U.S.C. § 1983 (1970). Section 1983 provides:

Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress.

The federal district court's original jurisdiction over a § 1983 cause of action is provided by 28 U.S.C. § 1343(3)-(4) (1970), which provides:

The district courts shall have original jurisdiction of any civil action authorized by law to be commenced by any person:

• • •
• • •

(3) To redress the deprivation, under color of any State law, statute, ordinance, regulation, custom or usage, of any right, privilege or immunity secured by the Constitution of the United States or by any Act of Congress providing for equal rights of citizens of or of all persons within the jurisdiction of the United States;

(4) To recover damages or to secure equitable or other relief under any Act of Congress providing for the protection of civil rights, including the right to vote.

his opportunity for complete recovery by seeking relief against both the culpable public employee and the municipality.⁵ In *Monroe v. Pape*,⁶ however, the Supreme Court held that municipalities are not "persons" within the ambit of section 1983,⁷ in effect granting municipal corporations immunity from civil liability under the Civil Rights Act. Focusing on the legislative history of the Act, the Court emphasized that the House of Representatives repeatedly had rejected the opportunity to impose such liability on local government units; consequently, the Court reasoned, municipalities could not be sued under section 1983.⁸

Although numerous attempts to circumvent the holding in *Monroe* have proved unsuccessful, the Court of Appeals for the Third Circuit in *Gagliardi v. Flint*⁹ recently upheld an action against a municipal corporation by finding the fourteenth amendment allegations sufficiently substantial to provide a jurisdictional basis for the federal forum to adjudicate pendent state claims. In addition to examining several approaches advanced by plaintiffs in attempts to provide federal courts with jurisdiction over municipalities, this Comment will analyze *Gagliardi* and the procedure approved by the Third Circuit. It concludes that the implementation

5. See notes 62-69 *infra* & accompanying text.

6. 365 U.S. 167 (1961).

7. *Id.* at 191. *Monroe* involved an action for damages against the city of Chicago and thirteen Chicago police officers who allegedly subjected the plaintiff, Monroe, to a brutal search and seizure in his home.

8. *Id.* at 191-92. The interpretation of § 1983 adopted by the Court in *Monroe* has been assailed vigorously by both the judiciary and commentators who have argued, for example, that this construction derives neither from legislative debate over the meaning of the word "person" nor from debate on § 1983 generally, but rather from congressional rejection of the Sherman amendment, which would have made local governments expressly liable for damages caused by their intentional infringement of certain constitutionally protected interests. Moreover, only the House of Representatives rejected the amendment, a repudiation based not on the determination that municipalities should be immune, but on the mistaken notion that the Congress lacked constitutional authority to impose liability on municipal corporations. See generally *Aldinger v. Howard*, 427 U.S. 1, 24-25 (1976) (Brennan, J., dissenting); *Gagliardi v. Flint*, 564 F.2d 112, 122-26 (1977) (Gibbons, J., concurring); *Kates & Kouba, Liability of Public Entities Under Section 1983 of the Civil Rights Act*, 45 S. CAL. L. REV. 131, 132-36 (1972); Note, *Damage Remedies Against Municipalities for Constitutional Violations*, 89 HARV. L. REV. 922, 924-25, 949-51 (1976) [hereinafter cited as *Damage Remedies*]; Note, *Developing Governmental Liability Under 42 U.S.C. § 1983*, 55 MINN. L. REV. 1201, 1205-07 (1971). But see Note, *Implying a Damage Remedy Against Municipalities Directly Under the Fourteenth Amendment: Congressional Action as an Obstacle to Extension of the Bivens Doctrine*, 36 MD. L. REV. 123 (1976) [hereinafter cited as *Implying a Damage Remedy*].

9. 564 F.2d 112 (3d Cir. 1977).

by federal courts of this jurisdictional basis will leave undisturbed *Monroe's* interpretation of section 1983 but will permit citizens to seek redress from many municipal corporations for constitutional infringements committed by their employees.

OBSTACLES TO IMPOSING LIABILITY ON A MUNICIPALITY IN FEDERAL COURT

Attempts to sue municipal corporations and thus to bypass the decision in *Monroe* have been based either on theories purporting to sustain independent causes of action in conjunction with federal question jurisdiction¹⁰ or on state claims deemed pendent to section 1983 actions against individuals included within that provision's definition of person. For example, in *Moor v. County of Alameda*,¹¹ decided by the Supreme Court in 1973, the plaintiffs argued that the incorporation into section 1983 of a California statute creating vicarious liability against local governments created an independent federal cause of action.¹² Under a separate federal statutory provision, codified as section 1988,¹³ state law may be incorporated into a

10. Two statutes arguably provide federal question jurisdiction for independent causes of action. 28 U.S.C. § 1331(a) (1970) provides: "The district courts shall have original jurisdiction of all civil actions wherein the matter in controversy exceeds the sum or value of \$10,000, exclusive of interest and costs, and arises under the Constitution, laws, or treaties of the United States." In addition, 28 U.S.C. § 1343(3) (1970) grants federal question jurisdiction for § 1983 causes of action. For the text of § 1343(3), see note 4 *supra*. In *City of Kenosha v. Bruno*, 412 U.S. 507 (1973), however, the Supreme Court determined that jurisdiction under § 1343 was unavailable in § 1983 suits against municipalities. *Id.* at 513; see notes 16-17 *infra* & accompanying text. The ambiguity in *Bruno's* holding has caused courts and commentators to argue that the case restricts the applicability of § 1343 solely to § 1983 actions. See *Blue v. Craig*, 505 F.2d 830, 837 (4th Cir. 1974) (§ 1343 and § 1983 co-extensive); Comment, *The Civil Rights Acts and Mr. Monroe*, 49 CAL. L. REV. 145, 148 (1961) ("authorized by law" in § 1343 refers to § 1983). *Contra*, *Gonzalez v. Young*, 560 F.2d 160, 166 (3d Cir. 1977); Bodensteiner, *Federal Court Jurisdiction of Suits Against "Nonpersons" for Deprivations of Constitutional Rights*, 8 VAL. U. L. REV. 215, 229-34 (1974); Hundt, *Suing Municipalities Directly Under the Fourteenth Amendment*, 70 NW. U. L. REV. 770, 772 n.13 (1975). Whether § 1343 provides jurisdiction for independent causes of action has not been expressly determined by the Court. See Bodensteiner, *supra*, at 234.

11. 411 U.S. 693 (1973). Plaintiffs sought to recover actual and punitive damages for injuries allegedly suffered when an Alameda County deputy sheriff, who was engaged in quelling a civil disturbance, wrongfully discharged a shotgun. Suit was brought against the individual sheriffs pursuant to 42 U.S.C. §§ 1983, 1985 (1970), and against the county under 42 U.S.C. §§ 1983, 1988 (1970). *Id.* at 695-96.

12. *Id.* at 698. Plaintiffs argued that 42 U.S.C. § 1988 (1970) permitted the incorporation of CAL. GOV'T CODE § 815.2(a) (West 1966) into § 1983 and that, consequently, federal jurisdiction over their action existed under 28 U.S.C. § 1343(4) (1970). 411 U.S. at 700-01. For the pertinent text of § 1343(4), see note 4 *supra*.

13. 42 U.S.C. § 1988 (1970) provides in pertinent part:

federal civil rights act whenever the federal law is "deficient in the provisions necessary to furnish suitable remedies."¹⁴ The Supreme Court, however, rejected the argument that section 1988 authorized the integration of California state law into section 1983, concluding that such an incorporation would be contrary to Congress' intent in enacting the latter section.¹⁵

One month after the decision in *Moor*, the plaintiff in *City of Kenosha v. Bruno*¹⁶ endeavored to restrict *Monroe*'s application to actions against municipalities for the recovery of damages and argued that section 1983 permits suits for equitable relief. Rejecting this argument, the Supreme Court held that municipal corporations are outside the ambit of section 1983, whether relief is sought in law or in equity.¹⁷ Thus, after *Monroe*, *Moor*, and *Bruno*, the Court conclusively had excluded municipalities as potential defendants in section 1983 suits.¹⁸

Plaintiffs' inability to sue municipal corporations under section 1983 encouraged them to resort to direct causes of action implicitly authorized by the Constitution. The basis for these actions was the 1971 decision of *Bivens v. Six Unknown Named Agents of Federal Bureau of Narcotics*,¹⁹ in which the Supreme Court permitted a damages suit against federal narcotics agents who allegedly had

[I]n all cases where [federal laws] are not adopted to the object, or are deficient in the provisions necessary to furnish suitable remedies and punish offenses against law, the common law, as modified and changed by the constitution and statutes of the State wherein the court having jurisdiction of such civil or criminal cause is held, so far as the same is not inconsistent with the Constitution and laws of the United States, shall be extended to and govern the said courts in the trial and disposition of the cause

14. *Id.*

15. 411 U.S. at 710. The Court evaluated the language and the legislative history of the Civil Rights Act of 1871, concluding both that § 1988 did not create an independent cause of action and that the attempted incorporation of the state statute into § 1983 would contravene the federal law as represented in *Monroe*. *Id.* at 703-09.

16. 412 U.S. 507 (1973). Bruno sought declaratory and injunctive relief against the cities of Kenosha and Racine, which had refused to renew his liquor licenses, allegedly because he permitted nude dancing in his taverns. In each case, the plaintiff named only the municipality as a defendant.

17. *Id.* at 513. As in *Moor*, see note 15 *supra*, the Court in *Bruno* relied on the statutory language as well as the legislative history of the Civil Rights Act of 1871 to support its determination that Congress did not intend to subject municipal corporations to a "bifurcated application" of § 1983 that would vary with the nature of the relief sought. *Id.*

18. For a listing of the governmental entities excluded from § 1983 liability, see Hundt, *supra* note 10, at 772 n.15; 47 Miss. L.J. 799, 802-03 & nn.25-29 (1976).

19. 403 U.S. 388 (1971).

deprived the plaintiff of his fourth amendment rights.²⁰ Although the facts in *Bivens* were limited to claims arising from fourth amendment violations, the case's result suggested that the infringement of any constitutional right could create a claim litigable in a federal court, thus permitting suits against municipalities.²¹

Attempting to extend the holding in *Bivens*, plaintiffs have argued that the fourteenth amendment protects their federal rights from infringement by state and local governments.²² The availability of the remedy recognized in *Bivens*, however, has been uncertain, and the lower courts have reached conflicting conclusions as to the case's applicability in suits against municipal corporations. Although some courts have restricted the scope of *Bivens* to fourth amendment violations,²³ others have extended the case's holding to all federal claims based on alleged constitutional infringements²⁴ and thus have permitted damages suits for alleged violations of the fourteenth amendment.²⁵ In addition to the judiciary's division over

20. *Id.* at 397.

21. See Bodensteiner, *supra* note 10, at 221; Hundt, *supra* note 10, at 772; *Damage Remedies*, *supra* note 8, at 926. Of course, a potential plaintiff must satisfy the jurisdictional requirements of 28 U.S.C. § 1331(a) (1970). For the text of § 1331(a), see note 10 *supra*.

22. For analyses of the use of *Bivens* to support a judicially created cause of action asserting fourteenth amendment rights directly against a municipality, see Bodensteiner, *supra* note 10, at 217-22; Dellinger, *Of Rights and Remedies: The Constitution as a Sword*, 85 HARV. L. REV. 1532 (1972); Hundt, *supra* note 10, at 772-75; *Damage Remedies*, *supra* note 8, at 929-59.

23. See, e.g., *Moore v. Schlesinger*, 384 F. Supp. 163, 165 (D. Colo. 1974); *Davidson v. Kane*, 337 F. Supp. 922, 924-25 (E.D. Va. 1972). See also *Cardinale v. Washington Technical Inst.*, 500 F.2d 791, 796 n.5 (D.C. Cir. 1974); *Archuleta v. Callaway*, 385 F. Supp. 384, 388 (D. Colo. 1974); *Smother v. Columbia Broadcasting Sys., Inc.*, 351 F. Supp. 622, 625-26 n.4 (C.D. Cal. 1972) (*dictum*).

24. *Brault v. Town of Milton*, 527 F.2d 730, 734 (2d Cir.), *vacated on other grounds*, *id.* at 736 (1975) (*en banc*); *accord*, *Gardels v. Murphy*, 377 F. Supp. 1389, 1398 (N.D. Ill. 1974) ("*Bivens* recognizes a cause of action for damages for violation of any constitutionally protected interest."); see *States Marine Lines v. Shultz*, 498 F.2d 1146, 1156-57 (4th Cir. 1974) (fifth amendment); *United States ex rel. Moore v. Koezler*, 457 F.2d 892, 894 (3d Cir. 1972) (fifth amendment); *Bethea v. Reid*, 445 F.2d 1163, 1164-65 (3d Cir. 1971), *cert. denied*, 404 U.S. 1061 (1972) (fourth and fifth amendments); *Williams v. Brown*, 398 F. Supp. 155, 156 (N.D. Ill. 1975) (fourteenth amendment); *Revis v. Laird*, 391 F. Supp. 1133, 1138-39 (E.D. Cal. 1975) (first and fifth amendments).

25. Fourteenth amendment claims have been recognized in suits involving, *inter alia*, police misconduct, *Redding v. Medicci*, 402 F. Supp. 1260, 1261 (W.D. Pa. 1975), *vacated on other grounds*, 411 F. Supp. 272 (W.D. Pa. 1976); *Williams v. Brown*, 398 F. Supp. 155, 156 (N.D. Ill. 1975) (illegal arrest and detention); mistreatment in prison, *Wattenberg v. New York City, Dep't of Correction*, 376 F. Supp. 41, 43-44 (S.D.N.Y. 1974) (cruel and unusual punishment); dismissals of public employees, *Hostrop v. Board of Jr. College Dist. No. 515*, 523 F.2d 569, 576-77 (7th Cir. 1975), *cert. denied*, 425 U.S. 963 (1976); *Skehan v. Board of*

the ultimate breadth of *Bivens*, several courts either have refused to recognize the existence of a constitutional cause of action against municipalities²⁶ or have been reluctant to adjudicate the issues involved in such suits.²⁷ The disparate holdings by lower courts concerning the applicability of *Bivens* have cast doubt on the viability of direct constitutional attacks against municipal defendants.²⁸

Alternative attempts to sue municipalities have been based on the theory of pendent jurisdiction, which "permits a plaintiff, in appropriate circumstances, to join with his federal claim a state claim over which the court has no independent basis of subject matter jurisdiction."²⁹ In *United Mine Workers v. Gibbs*³⁰ the Supreme Court articulated the two prerequisites for obtaining pendent

Trustees, 501 F.2d 31, 44 (3d Cir. 1974), *vacated on other grounds*, 421 U.S. 983 (1975); *Barszcz v. Board of Trustees of Community College*, 400 F. Supp. 675, 676 (N.D. Ill. 1975), *cert. dismissed*, 429 U.S. 1080 (1977); *see Singleton v. Vance County Bd. of Educ.*, 501 F.2d 429, 432-33 (4th Cir. 1974) (Winter, J., concurring and dissenting); racial discrimination, *Wright v. Houston Indep. School Dist.*, 393 F. Supp. 1149, 1152 (S.D. Tex. 1975) (backpay and reinstatement); *Robinson v. Conlisk*, 385 F. Supp. 529, 536 (N.D. Ill. 1974), *aff'd in pertinent part, rev'd on other grounds*, 549 F.2d 415 (7th Cir. 1977); deprivation of property without due process of law, *Amen v. City of Dearborn*, 532 F.2d 554 (6th Cir. 1976); *Brault v. Town of Milton*, 527 F.2d 730, 732-35 (2d Cir.), *vacated on other grounds, id.* at 736 (1975) (en banc); *Donohue Constr. Co. v. Maryland Nat'l Capital Park & Planning Comm'n*, 398 F. Supp. 21, 23-24 & n.2 (1975); *Stephens v. City of Plano*, 375 F. Supp. 985, 986 (E.D. Tex. 1974); *Grisson v. County of Roanoke*, 348 F. Supp. 321, 322 (W.D. Va. 1972); *see Dahl v. City of Palo Alto*, 372 F. Supp. 647 (N.D. Cal. 1974) (zoning); and other alleged constitutional violations. *See, e.g., Cox v. Stanton*, 529 F.2d 47 (4th Cir. 1975) (action for damages for sterilization under allegedly unconstitutional statute).

26. Courts often have dismissed § 1983 suits against municipalities without acknowledging that claims might exist under the fourteenth amendment. *See, e.g., Jones v. Marshall*, 528 F.2d 132 (2d Cir. 1975); *Burton v. Waller*, 502 F.2d 1261 (5th Cir. 1974), *cert. denied*, 420 U.S. 964 (1975); *Howard v. Cataldi*, 464 F.2d 272 (3d Cir. 1972).

27. The Third Circuit avoided reaching a decision on the merits of an action based directly on the fourteenth amendment in *Mahoney v. Waddle*, 564 F.2d 1018 (3d Cir. 1977). The Third Circuit also failed to decide the "difficult and troublesome constitutional questions" of "substantive liability and municipal immunity under the Fourteenth Amendment." *Fine v. City of New York*, 529 F.2d 70, 76 & n.13 (2d Cir. 1975). *See also Brault v. Town of Milton*, 527 F.2d 736, 738 (2d Cir. 1975) (en banc); *Apton v. Wilson*, 506 F.2d 83, 96 (D.C. Cir. 1974).

28. *See Gagliardi v. Flint*, 564 F.2d 112 (3d Cir. 1977), in which the majority and concurring opinions debated at length whether the Third Circuit has recognized such a cause of action. *Id.* at 115 n.3, 117-19. The principal rationale for rejecting the extension of *Bivens* to fourteenth amendment claims against municipalities derives from the concept of federalism and from the Court's interpretation of congressional intent underlying § 1983. *Damage Remedies*, *supra* note 8, at 927-29. *See also Hundt*, *supra* note 10, at 773-75; *Comment, Aldinger v. Howard and Pendent Jurisdiction*, 77 COLUM. L. REV. 127, 138 n.58 (1977) [hereinafter cited as *Pendent Jurisdiction*]; *Implying a Damage Remedy*, *supra* note 8, at 124-25.

29. *Pendent Jurisdiction*, *supra* note 28, at 128. For a comprehensive history of the doctrine's evolution, *see id.* at 129-35. *See also Aldinger v. Howard*, 427 U.S. 1, 6-16 (1976).

30. 383 U.S. 715 (1966).

jurisdiction: first, the federal claim must be of sufficient substance to confer subject matter jurisdiction on the court;³¹ and second, the state and federal claims must derive from a "common nucleus of operative fact",³² such that they ordinarily would be tried together in one judicial proceeding.³³ If these prerequisites were met, a plaintiff would make a municipality a pendent party by joining his state cause of action against the municipality to a section 1983 claim against the culpable official.³⁴

The Supreme Court's decision in *Aldinger v. Howard*,³⁵ however, limited the availability of this procedure. Distinguishing pendent claims from pendent parties, the Court held that the doctrine of pendent jurisdiction does not authorize the joinder of a state claim against a party over whom no independent federal jurisdiction ex-

31. *Id.* at 725.

32. *Id.* Decisions subsequent to *Gibbs* have held that a loose factual connection between the claims is sufficient to satisfy this "common nucleus" requirement. *See, e.g.,* *Klaus v. Hi-Shear Corp.*, 528 F.2d 225 (9th Cir. 1975); *Hamilton v. Chaffin*, 506 F.2d 904 (5th Cir. 1975); *Apton v. Wilson*, 506 F.2d 83 (D.C. Cir. 1974); *Burton v. Waller*, 502 F.2d 1261 (5th Cir.), *cert. denied*, 420 U.S. 964 (1974); *Vanderboom v. Sexton*, 422 F.2d 1233 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970); *Knuth v. Erie Crawford Daily Coop. Ass'n*, 395 F.2d 420 (3d Cir. 1968); *Gabel v. Hughes Air Corp.*, 350 F. Supp. 612 (C.D. Cal. 1972); *Bowman v. Hartig*, 334 F. Supp. 1323 (S.D.N.Y. 1971). If the two claims are totally independent, however, the district court may exercise its jurisdiction only over the federal action. *See, e.g.,* *PAAC v. Rizzo*, 502 F.2d 306 (3d Cir.), *cert. denied*, 419 U.S. 1108 (1974); *Hales v. Winn-Dixie Stores, Inc.*, 500 F.2d 836 (4th Cir. 1974); *Umdenstock v. American Mortgage & Inv. Co.*, 495 F.2d 589 (10th Cir. 1974); *Bowman v. White*, 388 F.2d 756 (4th Cir.), *cert. denied*, 393 U.S. 891 (1968); *Ryan v. New Castle County*, 365 F. Supp. 124 (D. Del. 1973); *Spens v. Citizens Fed. Sav. & Loan Ass'n*, 364 F. Supp. 1161 (N.D. Ill. 1973); *Ely v. Velde*, 356 F. Supp. 726 (E.D. Va. 1973); *Weiss v. Supasco*, 295 F. Supp. 824 (S.D.N.Y. 1969).

33. 383 U.S. at 725. The Court cautioned that the acceptance of pendent jurisdiction is discretionary with the court. In deciding whether to implement the doctrine, a court may consider, *inter alia*, judicial economy, convenience, fairness to the litigants, comity, federalism, the possibility of jury confusion, and the state claim's dominance in the action. *Id.* at 726-27.

34. A pendent party claim requires joinder of a new party "against whom or by whom no claim is asserted which has an independent jurisdictional base." Fortune, *Pendent Jurisdiction—The Problem of "Pendent Parties"*, 34 U. PITT. L. REV. 1, 1 (1972). For additional commentary on pendent party jurisdiction, see 13 C. WRIGHT, A. MILLER & E. COOPER, *FEDERAL PRACTICE AND PROCEDURE: JURISDICTION* § 3567 (1975); Bratton, *Pendent Jurisdiction in Diversity Cases—Some Doubts*, 11 SAN DIEGO L. REV. 296 (1974); Sullivan, *Pendent Jurisdiction: The Impact of Hagans and Moor*, 7 IND. L. REV. 925, 942-59 (1974); Note, *UMW v. Gibbs and Pendent Jurisdiction*, 81 HARV. L. REV. 657 (1968); Note, *Federal Pendent Party Jurisdiction and United Mine Workers v. Gibbs—Federal Question and Diversity Cases*, 62 VA. L. REV. 194 (1976); Comment, *Aldinger v. Howard and Pendent Jurisdiction*, 77 COLUM. L. REV. 127 (1977); Comment, *Pendent and Ancillary Jurisdiction: Towards a Synthesis of Two Doctrines*, 22 U.C.L.A. L. REV. 1263 (1975).

35. 427 U.S. 1 (1976).

ists.³⁶ A section 1983 suit against a municipal officer cannot provide a federal court with independent jurisdiction over a municipal corporation, which is exempt from such actions; consequently, *Aldinger* precludes the joinder of a state claim against a municipality with a federal claim brought under section 1983.³⁷ The decision in *Aldinger* thus further insulates municipalities from liability in federal courts for their constitutional violations.

JOINDER OF CONSTITUTIONAL AND PENDENT STATE CLAIMS

In *Gagliardi v. Flint*³⁸ the Court of Appeals for the Third Circuit sanctioned another procedure through which municipalities could be subjected to liability in federal courts for their infringement of plaintiffs' guaranteed federal rights. After her son had been fatally shot by a Philadelphia police officer, the plaintiff filed suit against the city in federal district court. The district court invoked its jurisdiction over the municipality as to two of the causes of action.³⁹ The plaintiff had based one of these claims directly on the fourteenth amendment, alleging a denial of life, and had asserted the other as a pendent state claim under the Pennsylvania Survival⁴⁰ and Wrongful Death Statutes.⁴¹ The Third Circuit affirmed.⁴²

Substantiality

The Third Circuit approved the use of the fourteenth amendment

36. *Id.* at 10.

37. See, e.g., Note, *Section 1983 and Federalism: The Burger Court's New Direction*, 28 U. FLA. L. REV. 904, 919 n.122 (1976) [hereinafter cited as *Federalism*].

38. 564 F.2d 112 (3d Cir. 1977).

39. *Id.* at 114.

40. The Pennsylvania Survival Statute, 20 PA. CONS. STAT. ANN. § 3371 (Purdon 1975), provides: "All causes of action or proceedings, real or personal, except actions for slander or libel, shall survive the death of the plaintiff or of the defendant, or the death of one or more joint plaintiffs or defendants."

41. The Pennsylvania Wrongful Death Statute, 12 PA. CONS. STAT. ANN. § 1601 (Purdon 1953), provides:

Whenever death shall be occasioned by unlawful violence or negligence, and no suit for damages be brought by the party injured during his or her life, the widow of any such deceased, or if there be no widow, the personal representatives may maintain an action for and recover damages for the death thus occasioned.

42. 564 F.2d at 114. The court based its jurisdiction on 28 U.S.C. §§ 1331, 1343 (1970). Although § 1331 federal question jurisdiction was not pleaded in the original proceedings, the court of appeals invoked 28 U.S.C. § 1653 (1970) to permit the plaintiff to amend the jurisdictional statement. 564 F.2d at 114. For the pertinent text of § 1331, see note 10 *supra*. For the pertinent text of § 1343, see note 4 *supra*.

claim in *Gagliardi*, not to hold the municipality liable, but to establish an independent jurisdictional basis enabling the district court to adjudicate the pendent state cause of action. By finding the constitutional claim sufficiently substantial to vest the district court with federal question jurisdiction,⁴³ the appellate court combined the *Bivens* and pendent jurisdiction doctrines to impose liability on a municipality without resort to section 1983.

Although the substantiality test has been characterized as "more ancient than analytically sound",⁴⁴ its use for determining federal jurisdiction nevertheless has been retained by the Supreme Court.⁴⁵ In *Gagliardi* the Third Circuit's determination that the plaintiff's fourteenth amendment claim was sufficiently substantial derived initially from the court's recognition that in *Mount Healthy School District Board of Education v. Doyle*⁴⁶ the Supreme Court expressly reserved the issue whether, by analogy to its decision in *Bivens*, a plaintiff could imply a cause of action directly from the fourteenth amendment that would not be subject to the limitations of section 1983.⁴⁷ The absence of a Supreme Court holding specifically deciding the question of the substantiality of a direct fourteenth amendment suit based on *Bivens*, combined with the numerous decisions in other courts permitting such causes of action,⁴⁸ indicated to the court that the constitutional claim was not so "devoid of merit as not to involve a federal controversy within the jurisdiction of the District Court."⁴⁹ Having obtained jurisdiction, the district court could adjudicate the pendent state claim, and the Third Circuit thus could avoid resolution of the difficult constitutional question⁵⁰ expressly reserved by the Court in *Mount Healthy*. Such an approach comported with the doctrine of judicial restraint in that constitutional issues unnecessary to the case's disposition were not adjudicated.⁵¹

43. 564 F.2d at 116.

44. *Rosado v. Wyman*, 397 U.S. 397, 404 (1970).

45. See, e.g., *Hagans v. Lavine*, 415 U.S. 528, 538 (1974); *Bell v. Hood*, 327 U.S. 678, 682-83 (1946).

46. 429 U.S. 274 (1977).

47. 464 F.2d at 115 (quoting 429 U.S. at 278).

48. See note 25 *supra*.

49. 564 F.2d at 116 (quoting *Hagans v. Lavine*, 415 U.S. 528, 543 (1974)).

50. See *Hagans v. Lavine*, 415 U.S. 528, 546-47 & n.12 (1974).

51. The Supreme Court repeatedly has indicated that the federal courts should refrain from the adjudication of constitutional issues when alternative grounds, including state claims, for disposing of litigation exist. See, e.g., *Hillsborough v. Cromwell*, 326 U.S. 620, 629

Consistency with Prior Case Law

By combining the fourteenth amendment and the pendent state claim, the Third Circuit did not contravene the prior standard espoused by the Supreme Court.⁵² Because a section 1983 suit was not used to support the pendent state claim, the court in *Gagliardi* was not bound by the Supreme Court's holding in *Monroe* that municipalities were not "persons" within the meaning of section 1983.⁵³ Moreover, the result in *Gagliardi* presents no conflict with the Supreme Court's holding in *Aldinger* that, for purposes of pendent jurisdiction, a federal court may not adjudicate state claims against a party over whom no independent federal jurisdiction exists.⁵⁴ *Aldinger* precluded the joinder of a state claim against a separate pendent party to a section 1983 cause of action under which the court could exercise no jurisdiction over the defendant in the state action. In *Gagliardi*, however, the City of Philadelphia was the defendant in both the federal and the state claims;⁵⁵ the Third Circuit thus permitted the joinder of a pendent state claim with a constitutional claim under which the district court already had attained a jurisdictional basis over the defendant municipality.

On the other hand, the two prerequisites for pendent jurisdiction enunciated in *Gibbs*⁵⁶ were present in *Gagliardi*. As previously noted, the constitutional claim, which alleged that the Philadelphia police officer's actions had deprived the plaintiff's son of his fourteenth amendment right to life, was sufficiently substantial to provide the district court with jurisdiction over the municipality.⁵⁷ In addition, both claims arose from the fatal shooting and clearly stemmed from a common nucleus of operative fact. Consequently, the existing case law did not preclude the district court's decision

(1946); *Cincinnati v. Vester*, 281 U.S. 439, 448-49 (1930); *Siler v. Louisville & N.R.R. Co.*, 213 U.S. 175, 193 (1909); *Seals v. Quarterly County Court*, 526 F.2d 216, 219 (6th Cir. 1975). See also *Hagans v. Lavine*, 415 U.S. 528, 545-49 (1974).

52. See notes 6-8, 11-18, 35-37 *supra* & accompanying text.

53. See notes 7-8 *supra* & accompanying text.

54. See text accompanying notes 35-37 *supra*.

55. For the proposition that the Court should extend the rationale in *Aldinger* from its application to pendent party jurisdiction to ordinary pendent jurisdiction, see *Pendent Jurisdiction*, *supra* note 28, at 148-49.

56. See notes 30-34 *supra* & accompanying text. A letter-brief filed by the City of Philadelphia with the court of appeals in *Gagliardi* protested vigorously the use of the fourteenth amendment cause of action to obtain federal jurisdiction because the plaintiff allegedly never relied on that portion of her complaint in the trial court. Letter-brief for Appellant at 4.

57. See text accompanying notes 46-49 *supra*.

to extend its jurisdiction to the pendent state claim.

Litigants attempting to use the procedure approved in *Gagliardi* must be certain that their claims based directly on the fourteenth amendment are substantial in nature.⁵⁸ This requirement, however, nevertheless permits the assertion of constitutional claims for a wide variety of injuries⁵⁹ because governmental actions have had an increasingly significant impact on individuals. Another potential obstacle to the assertion of the theory advanced in *Gagliardi* is the failure of state law to provide for a waiver of sovereign immunity. Absent such a waiver, a pendent state claim cannot be maintained, and the plaintiff could recover in federal court only if he litigated successfully a direct cause of action against the municipality under the fourteenth amendment.⁶⁰ This restriction presents little threat to suits against many municipalities, given the present trend to dispense entirely with municipal immunity.⁶¹

Policy Perspective

An injured plaintiff seeking relief for the deprivation of his federal rights by a municipal employee ideally would attempt to sue both the municipality and the individual committing the violation, to litigate the action in a federal rather than in a state tribunal, and to consolidate his federal and state claims through the use of pendent jurisdiction. Under the Third Circuit's approach in *Gagliardi*, each of these goals may be achieved.

58. See, e.g., *Hagans v. Lavine*, 415 U.S. 528, 536-38 (1974); *Bell v. Hood*, 327 U.S. 678, 682-83 (1946).

59. For example, in *Bell v. Hood*, 327 U.S. 678 (1946), plaintiff's allegation that the Federal Bureau of Investigation imprisoned him and subjected his home to a search was found to be a substantial claim. *Id.* at 683. In *Hagans v. Lavine*, 415 U.S. 528 (1974), the plaintiff's allegation that the operation of a welfare regulation designed to recoup certain payments from the plaintiff constituted a substantial deprivation was held to be sufficient to confer jurisdiction on the federal court. *Id.* at 538. But see *Paul v. Davis*, 424 U.S. 693 (1976), in which the Court cautioned that not every injury caused by a state official acting under color of state law could be deemed a substantial violation of the fourteenth amendment. *Id.* at 699. In *Davis* the Court concluded that the fourteenth amendment's guarantees of liberty and property rights do not protect individuals' reputations from defamation. *Id.* at 709.

60. For a discussion of the viability of a direct constitutional cause of action against a municipal defendant, see notes 22-28 *supra* & accompanying text.

61. For a compilation of cases in which states have abolished governmental immunity, see *Long v. Weirton*, ___ W. Va. ___, 214 S.E.2d 832, 854 (1975). The court in *Ayala v. Philadelphia Bd. of Pub. Educ.*, 453 Pa. 584, ___, 305 A.2d 877, 889 (1973), listed the position of the various states regarding the decline of governmental immunity under both statutory and common law. See also Note, *Developing Governmental Liability Under 42 U.S.C. § 1983*, 55 MINN. L. REV. 1201, 1216 n.75 (1971).

From a practical standpoint, allowing an injured citizen to sue both the municipal corporation and its culpable employee is preferable to restricting the imposition of liability to the individual perpetrator.⁶² Frequently, the commission of violations by groups of governmental employees hinders subsequent identification of the potential individual defendants. In such instances the victim may be denied adequate relief.⁶³

The partial immunity of public servants from legal liability further demonstrates the practical necessity of permitting plaintiffs to sue municipal corporations. The rationale for defenses such as good faith and scope of duty⁶⁴ is that the public's interest in the administration of laws requires the alleviation of a public servant's fear of personal liability for injuries resulting from the performance of his duties.⁶⁵ Public officials should not be so fearful of potential personal liability that they hesitate to perform their responsibilities; the victims of these officials' constitutional transgressions, however, should not be denied an adequate remedy. By providing compensation for these injured citizens, a municipality would not discourage individual officers from enforcing the law.⁶⁶

Even if public servants are not immune, juries often are sympathetic toward an officer who simply has attempted to perform his

62. The Court in *Monroe* acknowledged that it failed to weigh certain policy considerations in its decision to exempt municipalities from § 1983 liability. Specifically, the Court stated that it had not examined whether municipal corporations should be subject to liability because "private remedies against officers for illegal searches and seizures [were] conspicuously ineffective, and that municipal liability [would] not only afford plaintiffs responsible defendants but would cause those defendants to eradicate abuses that exist at the police level." 365 U.S. at 191.

After considering many of the policy implications of municipal immunity, the United States Commission on Civil Rights recommended that § 1983 be amended to reverse *Monroe* legislatively. Kates & Kouba, *supra* note 8, at 143 n.67 (citing U.S. COMM'N ON CIVIL RIGHTS, LAW ENFORCEMENT: A REPORT ON EQUAL PROTECTION IN THE SOUTH 179 (1965)).

63. See, e.g., *Burton v. Waller*, 502 F.2d 1265, 1271, 1281-82, 1284, 1286 (5th Cir. 1974), *cert. denied*, 420 U.S. 964 (1975) (court upheld acquittal of all 69 defendant police officers partially because plaintiffs failed to prove which particular policemen fired shots); *Howell v. Cataldi*, 464 F.2d 272, 279-84 (3d Cir. 1972) (affirmed directed verdict for two police officers alleged to have brutally beaten plaintiff: plaintiff failed to prove whether defendants were the policemen who administered beating).

64. Other such defenses include the absolute or qualified privileges held by some government officers. See, e.g., *Barr v. Matteo*, 360 U.S. 564, 569 (1959).

65. K. DAVIS, ADMINISTRATIVE LAW TREATISE § 25.17 (1970 Supp.).

66. The establishment of a system rendering municipalities liable for their employees' actions arguably could encourage governmental employees to violate the Constitution or, at least, could remove an important deterrent to such actions. *But see* text accompanying notes 70-71 *infra*.

duty.⁶⁷ Moreover, a plaintiff who successfully litigates his claim may be unable to collect from an officer who has limited funds.⁶⁸ By permitting an injured party to sue the municipality, however, both of these problems may be eliminated; juries would be less subjective in their evaluation of the merits of the plaintiff's action, and a successful litigant would be assured of receiving his entire damages award.⁶⁹

The imposition of municipal liability also would provide a more effective deterrent to future constitutional violations by public employees than does the unsatisfactory exclusionary rule or the sporadic imposition of individual tort liability.⁷⁰ The economic pressure of potential damages awards could provide municipal supervisors with a greater incentive to control their subordinates' conduct. Because supervisors would be required to enforce more strictly suspension or dismissal penalties against culpable employees, they consequently would encourage those employees to act only within the scope of their authority.⁷¹

Federal courts provide a forum preferable to state tribunals for adjudicating the type of state claims involved in *Gagliardi*. Initially, the federal district court's invocation of the pendent jurisdiction doctrine to join a federal and state claim not only provides a convenience for the litigants but also promotes judicial economy.⁷² With the consolidation of two potential proceedings into one, the parties incur lower court costs and avoid the problems raised by inconsistent adjudications or by the municipality's subsequent assertion of collateral estoppel as a defense.⁷³ In addition, adjudication by a federal district court judge, whose life tenure helps to insulate him from political pressure, may enable an injured plaintiff to avoid the potential for bias in a state judge's review of other state officials'

67. See *Damage Remedies*, *supra* note 8, at 926.

68. *Id.* Many municipalities, however, provide tort liability insurance for their employees.

69. See Hundt, *supra* note 10, at 779.

70. K. DAVIS, *supra* note 65, at § 25.17. See generally Hundt, *supra* note 10, at 782-83; Kates & Kouba, *supra* note 8, at 140-41; *Damage Remedies*, *supra* note 8, at 927; *Implying a Damage Remedy*, *supra* note 8, at 125-26.

71. K. DAVIS, *supra* note 65, at § 25.17.

72. *United Mine Workers v. Gibbs*, 383 U.S. 715, 726 (1966).

73. Minahan, *Pendent and Ancillary Jurisdiction of United States Federal District Courts*, 10 CREIGHTON L. REV. 279, 321 n.198 (1976). See generally Comment, *Section 1983 and the New Supreme Court: Cutting the Civil Rights Act Down to Size*, 15 DUQ. L. REV. 49, 89 (1976).

actions.⁷⁴ Finally, the selection of juries in federal proceedings from broad-based citizen pools helps to ensure their impartiality.⁷⁵

Critics contend that the procedure approved in *Gagliardi* of invoking pendent jurisdiction compromises federalism and forces federal courts to assume jurisdiction over a broad range of traditional state functions.⁷⁶ Under the doctrine established in *Erie Railroad v. Tompkins*,⁷⁷ however, federal courts have obtained vast experience in the adjudication and application of state law.⁷⁸ Should they commit errors of law, appellate review is available. Moreover, because a decision to accept pendent jurisdiction is discretionary with the court, federal judges will abstain from deciding state claims, even those properly joined with valid federal allegations, that require the expert consideration available only in a state court.⁷⁹

Others might argue that the extensive use of the pendent jurisdiction procedure will flood the federal court docket with frivolous claims.⁸⁰ Such actions could be rejected immediately, however, under the substantiality test,⁸¹ which authorizes dismissal of a pendent state claim "if the federal claim to which it is attached is

74. Chevigny, *Section 1983 Jurisdiction: A Reply*, 83 HARV. L. REV. 1352, 1358 (1970). See generally Kates & Kouba, *supra* note 8, at 145-46; 21 WAYNE L. REV. 1103, 1111-12 (1975).

75. See Jury Selection and Service Act of 1968, 28 U.S.C.A. §§ 1861-1871 (1970 & Supp. 1978). The United States Commission on Civil Rights discussed the problem of discrimination in state juries. See 21 WAYNE L. REV. 1103, 1112 & n.54 (1975), (citing [1961] COMM'N ON CIVIL RIGHTS REP. bk. 5, at 92-94 (1961)).

76. See *Federalism*, *supra* note 37, at 916. See generally Aldisert, *Judicial Expansion of Federal Jurisdiction: A Federal Judge's Thoughts on Section 1983, Comity, and the Federal Caseload*, 1973 LAW. & SOC. ORD. 557; Shakman, *The New Pendent Jurisdiction of the Federal Courts*, 20 STAN. L. REV. 262 (1968).

77. 304 U.S. 64 (1938). The Court in *Erie* held that federal common law is inapplicable in diversity cases and that, in such situations, a federal court must apply the substantive law of the state in which it sits. *Id.* at 78.

78. See *Day & Zimmerman, Inc. v. Challoner*, 423 U.S. 3, 4 (1975) (Blackmun, J., concurring); *Schneckloth v. Bustamonte*, 412 U.S. 218, 264 (1973) (Powell, J., concurring); *Bivens v. Six Unknown Fed. Narcotics Agents*, 403 U.S. 388, 400 (1970) (Harlan, J., concurring); *Gavlik Constr. Co. v. H.F. Campbell Co.*, 526 F.2d 777 (3d Cir. 1975).

79. See, e.g., *United Mine Workers v. Gibbs*, 383 U.S. 715, 726 (1966); note 33 *supra*.

80. Since 1961, the number of suits filed in federal courts under the Civil Rights Act of 1871 has increased more than forty-fold. Note, *Immunity of Teachers, School Administrators, School Board Members, and School Districts from Suit Under Section 1983 of the Civil Rights Act*, 1976 U. ILL. L.F. 1129, 1129 nn.2-3; see *Bivens v. Six Unknown Fed. Narcotics Agents*, 403 U.S. 388, 428-29 (1971) (Black, J., dissenting).

81. See *Bivens v. Six Unknown Fed. Narcotics Agents*, 403 U.S. 388, 391 n.4 (1971); Chevigny, *supra* note 74, at 1354 & n.14; notes 58-59 *supra* & accompanying text. This shifting process can be facilitated by requiring plaintiffs to plead facts with specificity, a procedure employed in the Third Circuit. See *Rotolo v. Borough of Charleroi*, 532 F.2d 920, 922 (3d Cir. 1976).

so insubstantial that it cannot serve as the basis for federal question jurisdiction under the general federal question statute."⁸² Inasmuch as plaintiffs will continue to bring section 1983 suits against municipal officers in federal courts, they simultaneously could assert their claims against the pertinent municipalities, and the two defendants could be tried concurrently. Ultimately, then, the approach approved in *Gagliardi* could reduce the total number of suits brought, in that all the federal and state claims deriving from a common nucleus of operative fact could be adjudicated in one proceeding.

CONCLUSION

In *Gagliardi v. Flint*, the Court of Appeals for the Third Circuit held that a claim against a municipality based on a fourteenth amendment violation by a government employee was sufficiently substantial to vest jurisdiction in the federal district court. Having jurisdiction, the district court adjudicated the pendent state claim and thus rendered unnecessary a decision on the constitutional question. This procedure provides an interim solution to a problem created by the Supreme Court's decision in *Monroe v. Pape*, which held that municipal corporations could not be sued under section 1983. It likewise is consistent with the Court's holding in *Aldinger v. Howard*, which precludes the joinder of a pendent claim against a separate party, because the municipal corporation would be the defendant in both the federal and state claims. In providing a federal forum in which victims of constitutional infringements by municipal employees can sue the municipalities directly, this approach permits complete economic remuneration for those plaintiffs who, for a variety of reasons, otherwise might be unable to recover from the particular wrongdoer.

82. *Hagans v. Lavine*, 415 U.S. 528, 542-43 (1974) (citing *Bell v. Hood*, 327 U.S. 678 (1946)).