Sham Transactions in the United States[[1]](#footnote-1)

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Policymakers in the US have noted that individuals and businesses have become alarmingly adept at using the letter of the law to obtain unintended benefits and advantages. This deception and pretense can be found in a wide variety of legal contexts, and includes activites and plans that are labeled “sham marriages,”[[2]](#footnote-2) “sham retirements,”[[3]](#footnote-3) “sham leases,”[[4]](#footnote-4) “sham litigation,”[[5]](#footnote-5) and so forth. Government lawyers note that these and other similar types of transactions have the appearance of law-abiding behavior, but are in fact nothing more than fraud. The problem for government litigators, however, is that many sham activities *are* entirely consistent with statutory and administrative law and thus are particularly difficult to challenge in court.

In this chapter, we focus on alleged corporate tax shams and the American judiciary’s response to these transactions when they are litigated in the high court. While US corporations have engaged in creative financial planning—or, in the government’s view, deceit and manipulation—in a wide range of legal areas, some of the most innovative, complex, and lucrative schemes have emerged with the help of the tax law. Accordingly, we focus on corporate tax planning in an effort to explain how and why US courts draw the line between law-abiding and abusive activities. In doing so, we aim to identify the factors that convince judges that certain behavior crosses the line from legal acceptability to abusive activity. Judicial treatment of alleged corporate tax shams has long been viewed as erratic,confusing, and indeterminate, but our study suggests that US courts are more more systematic than heretofore believed. We collected every US Supreme Court case that involved sham allegations between the years 1909-2011 and found that certain factors, such as accounting irregularities and requests for unusually large tax refunds, increase the likelihood that the justices will find the corporation has engaged in a sham transaction and thus should be denied the benefits claimed. We also found that the justicies have continually looked to these same factors throughtout the last century. We hope that our study provides transparency to judicial decision making in the context of corporate tax shams, but also into other legal contexts in which courts characterize ostensibly legal behavior as abusive and fraudulent.

Before we continue, we would like to clarify our terminology. In this chapter, a “sham transaction” refers to any corporate transaction or position that government lawyers urge courts to void on the theory that the corporation has unfairly used the laws to undermine policy aims and goals. To reach this conclusion, as we note below, US courts use a variety of judicially-created doctrines, such as the sham doctrine, the step transaction doctrine, the economic substance doctrine and so forth. Importantly, the activity that we study in this chapter is not fraudulent or illegal, but is nonetheless perceived to be “distortive,” “evasive,” and “manipulative.” The definition of a sham transaction that we have in mind appears is similar to that used in other countries, including Australia, New Zealand, and Canada. An important difference between these countries and the US, however, is that the US courts appear to be far more willing to unwind a transaction given its sham qualities while the judiciaries of the other named countries have expressed a strong resistance to unwinding a deal.[[6]](#footnote-6) Why this difference exists is unclear: perhaps US corporations are exceptionally aggressive, perhaps US judges are less tolerant of corporate machinations, or perhaps US judges rely heavily on the judicially-created sham doctrines due to the historic lack of statutory General Anti-Avoidance Rule similar to the one that exists in many other countries. We do not have the data to provide insight into these comparative issues, but we do have the data necessary to identify the factors that persuade US courts that a corporation has engaged in a sham activitiy. After we investigate shams in the US tax context, we provide a brief overview of the types of sham activities that US courts have considered in a variety of other legal contexts.

I.  
Corporate Tax Abuse and Judicial Uncertainty in the US

Taxes are a prime focus of corporate cost-reduction strategies. As discussed in detail below, tax planning offers a lucrative means to preserve corporate profits precisely because the tax law is so complex. US corporate managers may take advantage of explicit corporate tax preferences in the Internal Revenue Code (IRC). For example, they may purchase particular types of software or transportation vehicles that are entitled to highly accelerated depreciation. On the other hand, managers may pursue tax strategies that employ hyperliteral readings of the IRC that produce valuable tax benefits (such as tax deductions, tax credits, and tax exemptions) without having any meaningful effect on the economic positions of their corporations. The latter collection of tax strategies is widely perceived to be “abusive” because the plans fail to reflect economic reality and produce tax results that Congress never envisioned.

In the earliest forms of corporate tax abuse, corporations deployed relatively simple strategies. For example, business taxpayers attempted to characterize themselves as partnerships, which were not subject to entity-level taxation, as opposed to corporations, which were. In another early strategy, corporations frequently sought to eliminate corporate taxation by disguising payments to shareholders as items generating tax deductions, such as rental or salary payments, even though in reality such payments constituted nondeductible dividends. Other corporations attempted to manipulate the characterization of their tax years by exploiting differences between the calendar year and their fiscal year. In each case, corporations aimed to exploit ambiguities in the newly forming statutory law in order to reduce, or eliminate altogether, corporate tax liability.

Over the last century, corporate tax strategies have increased in variety and complexity. The mass marketing of these strategies by major accounting firms and other tax advisors in the late 1990s and early 2000s led to a corporate tax abuse boom that commentators described in terms such as an “epidemic,” a “crisis,” and a “beast” that must be “slay[ed].” Modern corporate tax abuse strategies often involve multiple transaction steps, parties, and tax jurisdictions. An abusive corporate tax strategy today may feature a transaction in which a corporation purchases millions of dollars of stock, sells that stock back to its original owner several minutes later, and then claims millions of dollars in foreign tax credits. Or it may involve multiple steps in which a corporation participates in a transaction with a Luxembourg bank that enables it to increase its tax basis in stock, which it then sells to a third party, generating a large tax-deductible loss. While the latest forms of abusive corporate tax strategies are certainly more sophisticated than their predecessors, their basic objective—avoidance of corporate tax liability through an application of tax law that Congress never envisioned—remains the same.

A. Anti-Abuse Standards in US Courts

Corporate tax abuse is distinct from other forms of tax noncompliance because its legitimacy is judicially determined ex post. To appreciate this distinction, consider corporate tax behavior that involves the violation of an explicit tax rule, such as claiming a fraudulent tax deduction for a business expense that never actually was incurred, an activity that is illegal ex ante. In other words, a clear tax rule informs corporate managers that a tax position is prohibited *before* they claim it on a corporate tax return. Now consider a tax strategy that corporate managers believe—or at least convince themselves they believe—complies with the literal language of the IRC. Although no explicit rule in tax law prohibits a corporation from claiming the resulting tax benefits, the Internal Revenue Service (IRS) may challenge the strategy and ask a court to declare it abusive ex post on the ground that it enables the corporation to obtain unintended tax benefits that clash with the IRC’s revenue-raising policy objectives*.* The most prominent anti-abuse standards that courts apply when considering whether or not to respect corporate tax strategies ex postare listed immediately below.

*Sham Transaction Doctrine*. Under this doctrine, a court disallows a taxpayer’s claimed tax treatment if it determines that the substance of the underlying transaction at issue lacked any purpose other than tax avoidance. For example, if a corporation’s tax position in a particular year stemmed from the corporation’s purchase of treasury notes, but the corporation did not actually purchase the notes, a court could reject the corporation’s tax position as a sham.

*Economic Substance Doctrine*. The precise contours of the “economic substance” doctrine have varied historically from court to court. But under this doctrine, many courts will respect a corporation’s claimed tax treatment of a transaction only if (1) the corporation possessed a non-tax business purpose in pursuing the transaction and (2) the transaction meaningfully improved the corporation’s economic position (apart from reducing its tax liability).

*Substance over Form Doctrine*. Consistent with the principle that the government should not tax economically similar transactions differently, a courts also apply the “substance over form” doctrine. In doing so, the court ignores the transaction’s form and instead taxes the transaction based on its underlying economic substance.

*Step Transaction Doctrine*. Lastly, the “step transaction” doctrine enables a court to reject a corporation’s tax position by integrating a “series of formally separate ‘steps’ as a single transaction” and then by applying the appropriate tax treatment to the integrated transaction. The effect of this integration is often to treat portions of the transaction—individual steps—as if they never occurred, thereby eliminating the sought-after tax benefits.

B. Judicial Uncertainty in the US

US tax lawyers and scholars have commented for generations that the courts apply anti-abuse standards in unpredictable ways. Some commentators focus on the vague elements incorporated into particular standards (such as the business purpose requirement), arguing that as a result of their breadth, these standards “apply to everything and nothing.” Others focus more closely on the difficulty of distinguishing among the various standards—for example, they claim that different versions of the step transaction doctrine are not very different from one another. Many highlight cases that involve similar facts but that nonetheless result in different judicial outcomes. Regardless of their specific criticisms, many commentators argue that the possible application of one or more judicial anti-abuse standards introduces uncertainty into the practice of corporate tax planning.

Predicting whether a court will apply a particular judicial anti-abuse standard, or any standard at all, is challenging. While one court may respect the separate, independent steps of a taxpayer’s transaction, a different court may review the same transaction and determine that the steps should instead be viewed, and taxed, as one. Figure 1 draws on the insights of Professor Kyle Logue[[7]](#footnote-7) and illustrates the challenge of identifying transactions that may be characterized as “abusive” by describing the judicial characterizations that may apply to corporations’ tax reduction strategies:

Figure 1

Continuum of Corporate Tax Planning Controversies

**Legal**

**Legal, *ex ante*;**

**Abusive, *ex post***

**Illegal**

Figure 1

Continuum of corporate tax planning controversies

**Legal**

**Legal, *ex ante*;**

**Abusive, *ex post***

**Illegal**

At the left end of the continuum are legal activities. This category includes clearly permissible tax positions, such as a corporation’s decision to apply the correct tax rate to its established tax liability. This category may also include more aggressive, yet permissible, strategies. At the right end of the continuum are clearly illegal activities, such as a corporation’s decision to claim a business expense for high salary expenses that it never actually incurred. The middle section of the continuum represents corporate tax abuse: tax positions that are consistent with the letter of the tax law and are legal ex ante, but produce tax benefits that Congress did not intend and are labeled abusive ex post. Individuals involved in corporate tax planning expend significant effort endeavoring to determine ex antewhether a court will view a particular tax strategy as crossing the aggressive but legal line—that is, the line between legal corporate tax minimization (on the left side of the continuum) and abusive corporate tax evasion (in the middle of the continuum).

Given the uncertain nature of the judicial anti-abuse standards, individuals disagree on the factors that are most critical to a court’s decision to reject a corporation’s claimed tax treatment. In this Subpart, we examine the respective methodologies that three different groups of individuals—government officials, practitioners representing taxpayers, and scholars—have applied when engaging in this inquiry.

1. US Government Officials

US Government officials have identified several factors that they believe are relevant to determining whether or not a court will respect a corporation’s tax position. One source of these factors is the broad set of disclosure requirements with which corporations (and other types of taxpayers) must comply.[[8]](#footnote-8) Under these rules, corporations must file special disclosure forms with the IRS whenever they engage in transactions that bear certain “red flag” traits. While the purpose of these disclosure forms is to enhance the detection efforts of the IRS, they indirectly reveal the types of factors that government officials believe influence a court. Another source of government officials’ beliefs is the IRS’s internal administrative guidelines. The guidelines explain how IRS agents should address the newly codified economic substance doctrine and related tax penalties.[[9]](#footnote-9) The following are some of the most significant factors that appear in the IRS’s administrative guidance:

*Loss Transactions*. The government requires corporations to disclose transactions that invovled claimed losses of $10 million or more in any single taxable year. Not every tax loss claimed by a corporation is the result of corporate tax abuse, but government officials believe large tax losses signal the possibility of corporate tax abuse. In addition, government officials believe that courts are likely to view a tax strategy as abusive if the underlying transaction enables the corporation to “accelerate[] a loss or duplicate[] a tax deduction.”

*Book-Tax Differences*. Corporations have two distinct income reporting mechanisms. They report income for tax purposes on their federal tax returns (taxable income), but they also report income in corporate financial documents for purposes of informing shareholders and potential investors (book income). Large corporations are required to reveal and explain differences between these two types of income by filing a special disclosure form with the IRS. This requirement indicates that policymakers believe that a court should consider book-tax differences in a corporation’s treatment of a particular item when determining whether the corporation engaged in an abusive tax strategy.

*Third Parties*. IRS administrative guidance documents also indicate that a court may find the application of the economic substance doctrine appropriate in cases when a corporation’s transaction did not feature arm’s length dealings with third parties.

*Economic Change.* Finally, the IRS states that the application of the economic substance doctrine may be appropriate for transactions that create “no meaningful economic change on a present value basis” before considering tax consequences. This statement confirms that government officials believe that courts may reject tax positions that lack corresponding real-world economic effects.

2. US Tax Practitioners

Corporate tax lawyers devote significant time and energy to advising clients on the likelihood that courts will either respect their transaction or label it as abusive. Two of the factors that many “experienced tax professionals” believe will cause a court to designate a corporation’s tax strategy as abusive are described as follows:

*Business Purpose*. When practitioners analyze the probability that a court will apply a judicial anti-abuse standard to unwind a corporation’s transaction, they often focus on the strength of the business purpose underlying the transaction. As Ferguson argued, courts are likely to respect transactions that “are grounded on long-understood principles of business purpose and economic substance.”[[10]](#footnote-10) Regarding the specifics of the type of purpose that a transaction should serve, Canellos advised: “Real transactions, most obviously, have as their origins and purpose making money in the short-run or the long-run by increasing revenues or reducing (non-tax) expenses.”[[11]](#footnote-11) For tax practitioners, business purpose is often one of the most important factors considered when analyzing the potential judicial merits of the tax treatment of the transaction.

*Multiple Parties and Convoluted Steps.* Transactions that involve more than one party or multiple steps appear convoluted and complex and thus also raise a red flag. Tax practitioners are especially wary of constructing tax strategies that contain contrived steps or involve so-called accommodation parties, such as tax-exempt or foreign entities, which corporations often use to absorb taxable income resulting from their overall transactions.

3. US Tax Scholars

Tax law scholars generally do not advise clients on transaction structures or issue legal opinions. Instead, scholars tend to make normative claims with respect to how judges *should* decide corporate tax abuse cases and then provide prescriptive suggestions, such as concrete tests that judges should apply or legislation that Congress should enact. Implicit in these normative and prescriptive arguments, however, are positive claims regarding judicial behavior in corporate tax abuse cases. Several of these implicit positive claims are described below.

*Intent.* Scholars have implicitly argued that judges in corporate tax abuse controversies focus excessively, even incorrectly, on arguments regarding the intent of the taxpayer. Professor Leandra Lederman, for example, has criticized the current economic substance decisions for “shift[ing] from a focus on congressional intent to a focus on the taxpayer’s intent,”[[12]](#footnote-12)and others, including Professor Martin McMahon, have echoed this view. In addition, Professor Shannon Weeks McCormack has offered a detailed policy proposal, which would focus the attention of judges who hear corporate tax abuse controversies on the purpose of the tax laws.[[13]](#footnote-13) Regardless of the specific policy prescription offered, each of these scholars implicitly has argued that judges in corporate tax abuse cases do not examine adequately the intent of the legislators who drafted the applicable tax statutes, as judges instead excessively scrutinize the intent of the taxpayers in structuring and implementing their transactions.

*Textualism and Justice Scalia.* Another implicit positive claim that some scholars have offered relates to textualism and its increasing importance for American judges. Scholars point to the judicial appointment of Justice Antonin Scalia as having an effect on corporate tax abuse controversies. As Professors Dean and Solan have commented in the context of corporate tax abuse: “Since his appointment to the Supreme Court in 1986, Justice Scalia’s ‘new textualism’ has been seen as a challenge to an intent-oriented approach to statutory interpretation.”[[14]](#footnote-14) Interestingly, an Australian Justice recently noted that Austrialian courts have long taken a literal approach to the interpretation of the law, thereby upholding many seeminly abusive corporate tax schemes.[[15]](#footnote-15) This is precisly the view that scholars attribute to Justice Scalia and the American textulists in the judiciary.

*Alternative Proposals.* Finally, tax scholars have offered a plethora of judicial, administrative, and legislative proposals for controlling corporate tax abuse. They believe that their proposals would be more successful than judicial anti-abuse standards, which are unable to “protect the collection of income tax from assault by abusive shelter planners.”[[16]](#footnote-16) By offering these alternatives, scholars implicitly argue that judges in corporate tax abuse controversies fail to apply the current anti-abuse standards in a reliable and effective manner.

As the discussion thus far reveals, judicial decisionmaking in corporate tax abuse controversies is grounded in a range of interrelated anti-abuse standards. These standards appear to govern in a highly uncertain fashion.Government regulators, practitioners, and scholars have proffered a wide range of views with respect to judicial decisionmaking in the corporate tax abuse context, but there is no consensus as to what courts *actually* do.Our study adds to the positive literature but adopts a different approach. Whereas the previous studies have focused on a small collection of cases and provided qualitative insights, we have collected the entire population of corporate tax abuse cases litigated in the U.S. Supreme Court and used quantitative methods in an effort to understand how the Justices view corporate tax abuse.

II  
A Study of Corporate Tax Abuse in the US Supreme Court

A. The Data and the Models

Our discussion suggests that while scholars and commentators widely agree that corporate tax abuse exists, there is no universally accepted definition of the phenomenon—which creates high levels of uncertainty in the federal courts. Paradoxically, this fact does not pose a problem for our empirical study. Because we only seek to understand the factors that explain Supreme Court decisions, we need not settle on a single definition of corporate tax abuse. Rather, we need identify only the cases in which the government *alleged* abuse and then determine how the Justices reached a decision in the controversy.

To identify and analyze corporate tax abuse we designed a data collection process with the following three steps collected 919 federal tax cases in the US Supreme Court decided between 1909 and 2011. We then read each opinion and determined that 364 cases involved a corporate tax controversy—that is, one that involved corporate rather than individual tax liability. Finally, we read the government’s briefs filed with the Court in each of the corporate tax cases, and identified 137 controversies that involved allegations of abuse. The government did not prevail in all 137 cases, and this raises the empirical question: What are the factors that lead the Court to agree with the government in some of these cases but to reject the claims of abuse in others?

Figure 2 depicts the three groups of cases uncovered in our data collection efforts. The light grey area denotes the superset of 919 tax cases decided over the course of the last century, the dark grey area denotes the set of 364 corporate tax cases, and the black area indicates the subset of 137 corporate tax abuse cases as defined above.

Figure 2

Three groups of tax cases on U.S. Supreme Court docket



In an effort to understand and explain US Supreme Court decisionmaking in the corporate abuse context, we created three models. In the first two models, we investigate how the US government fares in abuse cases versus (1) all other types of tax controversies and (2) other types of coporporate tax controversies. More specifically, we seek to determine whether the government is more (or less) likely to prevail in the Supreme Court in cases where it alleges corporate tax abuse compared to cases that do not involve such allegations.

The dependent variable—the thing that we hope to explain—in our first model is the Court’s decision in any given federal tax case (raising *any* type of issue, corporate or not) and in our second model, the dependent variable is the Court’s decision in a given *corporate* tax case. In both models, the explanatory variable of interest is a government allegation contending that the corporation engaged in an abusive transaction or took an abusive accounting position; roughly fourteen percent of our cases invovled allegations of abuse. This variable will indicate whether corporate tax abuse cases are easier or harder to win for the government compared to the other types of tax cases that the Supreme Court decides*.* In the abuse controversies, as discussed above, both the government and the corporate taxpayer have viable legal arguments. The government argues that the corporation should not obtain the tax consequences it desires because tax laws should not be used in a manner that undermines their legislative intent and revenue-raising potential. The taxpayer, by contrast, argues that it followed the letter of the law and thus is entitled to its preferred tax outcome. We expect that the government will encounter more difficulty prevailing in cases that rest primarily (or solely) on public policy considerations related to abuse, compared to other types of cases that implicate, for instance, disputes associated with statutory or regulatory interpretation.

The first two models investigate a very simple question: Does the government have an easier or more difficult time winning corporate tax abuse cases than other types of tax cases that it litigates in the Supreme Court? The more interesting inquiry—and the point of this study—addresses the factors that are most likely to convince the Court to decide in favor of the government when abuse is alleged. After all, we expect the government to have a more difficult time winning abuse cases, but we know it does win sometimes.

For purposes of answering this final empirical question, we found that when government lawyers seek to convince the Court to invoke an anti-abuse doctrine, they routinely point to a small collection of very specific facts and circumstances. Three of the factors are tied to the nature of the transaction itself and two are linked to the position taken by the corporation on its tax return filed with the IRS. These five factors are: (1) the presence of third parties in the transaction; (2) multistep transactions; (3) the lack of a business purpose other than tax avoidance; (4) accounting irregularities, such as book-tax differences; and (5) a claim for a tax refund on the initial return. Table 1 below presents the frequency of these allegations in government briefs.

Table 1

Indicia of corporate tax abuse

|  |  |
| --- | --- |
| *Indicia of  Corporate Tax Abuse* | *Number of*  *Government’s Briefs Which Raised Allegation* |
| (1) Third Party | 65 (47%) |
| (2) Multistep Transaction | 50 (36%) |
| (3) Lack of Business Purpose | 34 (24%) |
| (4) Accounting Irregularity | 39 (28%) |
| (5) Request for Tax Refund | 19 (14%) |
| Any Indicia | 111 (81%) |
| Total Observations | 137 (100%) |

In addition to the facts and circumstances alleged in the briefs, scholars have argued that the government is less likely to prevail after 1986 given Justice Scalia’s ascension to the Supreme Court in 1986 and the attendant rise in the plain meaning approach to statutory interpretation.

To identify the effects of all these factors, we created a third model that seeks to explain judicial outcomes in cases involving alleged corporate tax abuse. Our explanatory variables of interest are the variables listed in table 1, third party, multistep transaction, lack of buisness purpose, accounting irregularity, and request for a refund. To test the effect of Justice Scalia, we created the variable Justice Scalia, if the year the Court heard oral arguments was post-1986 and 0 otherwise. As to our modeling expectations, we have developed the following hypotheses. The presence of third parties, multi-step transactions, the lack of a business purpose, accounting irregularities, and refund claims are all indicia of corporate tax abuse, and consequently we expect that the presence of these variables will increase the likelihood that the Justices will side with the government. We expect the presence of Justice Scalia to negatively correlate with judicial outcomes, because his approach prioritizes the plain meaning of the tax statute over public policy concerns.

B. Empirical Findings

We now turn to our empirical findings. We use probit models, but because probit coefficients are difficult to interpret we present our results in a different format: The findings reflect the marginal change in the probability that the government will win a case given a unit increase in the independent variable.[[17]](#footnote-17)

1. Are Corporate Tax Abuse Cases More Difficult to Win?

To begin our investigation, we focus on the first two models, which enable us to compare how the government fares in the corporate tax abuse cases vis-à-vis all other types of tax cases that are litigated in the Supreme Court. We theorized that allegations of abuse are not winning arguments in the High Court. Our results confirm this hypothesis. Column (1) of Table 2 indicates that the government is 7% less likely to win a corporate tax abuse case than other tax cases generally. Column (2) indicates the government is 8% less likely to win a corporate tax abuse case compared to corporate tax cases raising alternative legal issues. Neither of these results are statistically significant, even at the 0.10 level. Our dataset includes Supreme Court controversies decided over the course of the last century, which raises the question of whether our results would be the same if we examined a subset of cases decided in the more recent era. We reexamined the cases decided after World War II and present our findings in columns (3) and (4) of Table 2 below. Our results show an even stronger, and significant, negative correlation: The government is 18% less likely to prevail in the post–World War II period when it alleges corporate abuse. This finding is statistically significant in both models at the 0.05 level, indicating strong empirical evidence that the type of argument set forth in the government’s briefs has an effect on outcomes.

Our findings suggest that, as expected, the Supreme Court is sympathetic to corporations that adhere to the letter of the tax law, even if the transactions and tax positions undermine the revenue-raising potential of the tax law. It is, in short, more difficult for the government to prevail when all parties agree that the corporate taxpayer complied with the formal tax rules, yet the government alleges that the taxpayer nevertheless engaged in abuse.

Table 2

Corporate tax abuse cases are more

difficult for the government to win

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| U.S. Supreme Court Outcomes  Results depict change in the probability of a pro-government outcome, given a unit increase in the independent variable | | | | |
| *Explanatory Variable* | *All*  *Tax Cases*  (1) | *Corporate*  *Tax Cases*  (2) | *All*  *Tax Cases*  *Post-WWII*  (3) | *Corporate*  *Tax Cases*  *Post-WWII*  (4) |
| *Corporate Tax Abuse Case* | -.07  (.05) | -.08  (.05) | -.18  (.08)\*\* | -.18  (.09)\*\* |
| *Probability of Pro-Government Outcome at X-bar* | .68 | .68 | .71 | .68 |
| *Total Observations* | 850 | 341 | 304 | 106 |

Note: Results marked \*\*\* are statistically significant at the .01 level, \*\* are statistically significant at the 0.05 level, and \* are statistically significant at the 0.10 level. Errors are clustered by Chief Justice. All models include controls for judicial political preferences, the economy, defense spending, the identity of the petitioning party, and a time trend.

Our methods enable us to predict whether an allegation of corporate tax abuse will improve or detract from the government’s case on average, but we can also use the models to predict the likelihood that the government will prevail in *specific* cases. For example, conditional on the factors for which we have controlled in the model presented in column (4) of Table 2, we predict that the government had a 75% chance of winning in *Corn Products v. Commissioner* (the government won), a 48% chance of winning in *Cottage Savings Ass’n v. Commissioner* (the government lost), and a 45% chance of winning in *United Dominion Industries, Inc. v. United States* (the government lost). This small sampling of results suggests that our initial models perform very well.

Although corporate tax abuse cases are more difficult for the government to win than other types of cases, it is useful to note that, aside from a few exceptional years, the government has had a greater than 50% chance of winning. In fact, on average, the government prevailed in 61% of all the corporate tax abuse cases it litigated since 1909. This suggests that while the government may have a weaker case in corporate abuse controversies compared to other types of tax controversies, nevertheless it is likely to prevail if the dispute reaches the Supreme Court. Thus, while a corporate taxpayer’s chance of prevailing increases in the abuse cases, corporations always seem to be at a disadvantage. For purposes of comparison, the judicial anti-abuse doctrines do not seem to play such a strong role in other countries, such as Australia, New Zealand, and Canada.[[18]](#footnote-18)

2. What Explains US Supreme Court?

We now move from comparisons between abuse and non-abuse controversies and focus solely on the abuse cases. We use the third model described above to determine which factors enhance and undermine the government’s chances of winning. For discussion purposes, we begin by focusing on the transaction-related variables associated with corporate tax abuse. We then turn to the cases involving accounting irregularities and refund claims. Finally, we examine Justice Scalia’s role in the decisionmaking process.

Table 3

Factors that explain outcomes in corporate tax abuse cases

|  |  |  |  |
| --- | --- | --- | --- |
| U.S. Supreme Court Outcomes  Results depict change in the probability of a pro-government outcome given a unit increase in the independent variable | | | |
| *Explanatory Variable* | *Corporate Tax Abuse Cases* | | |
|  | (1) | (2) | (3) |
| *Third Party Involved* | -.21  (.05)\*\*\* |  | -.36  (.13)\*\*\* |
| *Multistep Transaction* | -.03  (.08) |  | -.35  (.09)\*\*\* |
| *Lack of Business Purpose* | .07  (.07) |  | .29  (.15) |
| *Count (Total Number of Allegations)* |  | -.06  (.04) |  |
| *Third Party & Multistep* |  |  | .50  (.07)\*\*\* |
| *Third Party & Lack of Business Purpose* |  |  | -.22  (.19) |
| *Multistep & Lack of Business Purpose* |  |  | -.26  (.26) |
| *Accounting Irregularity* | .18  (.09)\* | .22  (.08)\*\* | .15  (.10) |
| *Taxpayer Claimed Refund* | .28  (.09)\*\*\* | .24  (.09)\*\* | .22  (.06)\*\*\* |
| *Justice Scalia on Court* | -.05  (.15) | -.09  (.18) | -.01  (.13) |
| *Probability of Pro-Government Outcome at X-bar* | .63 | .63 | .64 |
| *Total Observations* | 123 | 123 | 123 |

Note: Results marked \*\*\* are statistically significant at the 0.01 level, \*\* are statistically significant at the 0.05 level, and \* are statistically significant at the 0.10 level. Errors are clustered by Chief Justice and inlcude the same control variable used in the first two models. All models include controls for judicial political preferences, the economy, defense spending, the identity of the petitioning party, and a time trend.

a. Transaction-Related Factors

The legal briefs filed with the Supreme Court indicate that the government continually points to three transaction-related indicia of abuse: (1) the presence of a third party; (2) multistep transactions; and (3) the lack of a non-tax business purpose. As indicated in column (1) in Table 3, we found that the presence of third parties and multistep transactions decreasethe probability that the government will win by 21% and 3%, respectively, although only the finding on third parties is statistically significant—thus it is the only finding in which we can have confidence. With respect to the lack of a business purpose, the government is 7% more likely to prevail when it alleges this factor. But, this finding is not statistically significant and provides weak evidence against the null hypothesis that this variable is playing no role in the decisionmaking process. Only one finding achieves significance—the presence of third parties. While this fact may look suspicious to government litigators, it appears that the American Justices disagree. Perhaps the Justices believe that the presence of an outside party indicates an arm’s-length transaction that should be respected and not disregarded, as advocated by the government. These results are not what we expected, yet they may suggest what many American tax scholars and commentators have argued for years: U.S. courts are unpredictable when deciding corporate tax abuse controversies.

The results presented in column (1) of Table 3 depict the effects of each of these three case-related factors separately, but what if the government alleges two or more factors simultaneously? Perhaps the Court is more likely to unwind an otherwise legal corporate tax strategy when the government musters a strong case with numerous indicia of abuse. To test this hypothesis, we created a *count* variable that represents the number of factors alleged. It is coded as equal to 0, 1, 2, or 3, indicating the number of these factors alleged concurrently in each case. Column (2) of Table 3 presents our findings with respect to the *count* variable and indicates that the presence of more than one abuse factor actually decreasesthe probability that the Court will side with the government, although this finding is not statistically significant. The results associated with the *count* variable indicate that, as the number of transaction-related allegations increase, the probability of a pro-government outcome decreases by 6%. This finding suggests that even if the government believes certain factors indicate abuse, pointing to an increasing number of the factors is not a winning strategy. Again the model implies support for critics of judicial decisionmaking in the abuse context: The outcomes are unpredictable and perhaps counterintuitive.

To further probe the effects of the transaction-related variables, we examined specific combinations of the factors on the theory that while the Court is not convinced by an increasing number (or count) of allegations, the Justices may be persuaded by specific combinations or groupings. Perhaps specific combinations of factors may serve as convincing evidence of abuse, whereas factors cited alone or factors randomly grouped together may not have the same probative value. Accordingly, we investigated cases in which the government alleged the following combinations: (1) third parties and multistep transactions; (2) third parties and the lack of business purpose; and (3) multistep transactions and the lack of business purpose.[[19]](#footnote-19) Column (3) of Table 3 presents our findings and suggests that the precise blend of factors is important to the decisionmaking process.

To understand the results presented in column (3) of Table 3, first note that the column reports empirical findings for each variable separately and then in the three unique combinations. The three variables listed separately indicate the effects of the variable when it is alleged andwhen the others are *not* alleged. Thus, we see that when the government *only* alleges the presence of a third party, it is 36% lesslikely to win; when it alleges *only* a multistep transaction it is 35% lesslikely to win; when it alleges *only* the lack of a business purpose it is 29% more likely to win. The first two factors, standing alone, hurt the government at statistically significant levels, but when the government alleges only the lack of a business purpose the finding is not statistically significant and thus we cannot have confidence in the finding.

Now consider the three unique combinations of the variables presented in column (3) of Table 3. While the interpretation of these terms is somewhat more complex than the other terms in the model, we begin by noting that the results presented indicate the following: When third parties *and* multistep transactions are alleged together, the government is 50% morelikely to win. This combination convinces the Court, at a 0.01 statistically significant level, that the corporation engaged in a transaction that the judiciary should not support. The other two combinations, by contrast, do not exert the same positive effect on the Court. When third parties and a lack of business purpose are combined in the government’s argument, the government is 22% lesslikely to prevail. When the government alleges multistep transactions and a lack of business purpose it is 26% less likely to prevail—though neither of these two findings is statistically significant. The government’s actual win rate confirms these findings: The government prevailed in 60% of the cases that involved third parties and multistep transactions; it prevailed in 50% of the cases involving third parties and an alleged lack of a business purpose; and it prevailed in just 45% of the cases that involved multistep transactions and the alleged lack of a business purpose.[[20]](#footnote-20)

In sum, we see that a single indicator of abuse does not convince the Court that the Justices should deny the corporation its preferred tax outcome. The government appears to be more effective when it alleges multiple indicia of abuse—but only if certain combinations are present, not simply an increasing number of allegations. Specifically, the government should point to third parties and multistep transactions—two objective fact-based allegations—in order to increase its chances of winning. Third parties combined with a lack of business purpose, or a multistep transaction combined with a lack of business purpose—one fact-based allegation and the other a matter of opinion—is not a winning combination and together operate to decrease the likelihood that the Court will find in favor of the government. These findings, taken together, suggest that the presence of the third-parties and multistep transactions generally make the government’s case substantially weaker with one exception: when they are present together in a transaction that the government believes to be abusive. Finally, the results presented in Table 3 above indicate that the business purpose test is not playing a strong role in the Court’s decisionmaking process. Indeed, it appears to play little or no role when standing alone and a negative role when combined with other factors.

b. Tax Return Factors

We now turn to the items on the corporate tax return that raise a red flag of abuse. We begin with accounting irregularities, such as an asymmetry in the amount of income reported on corporate financial accounting documents and on the corporate tax return filed with the IRS. Columns (1), (2), and (3) of Table 3 indicate that when the government points to an accounting irregularity in its legal brief filed in Court, it is 15% to 22% more likely to prevail. This finding is statistically significant in two of the three models, suggesting that accounting irregularities increase the chances that the Justices will find that the corporation sought an inappropriate tax advantage.

We next consider loss transactions that a corporation might use to claim a refund on its tax return filed with the IRS, where the IRS subsequently denied the corporation’s claim. As noted above, corporate refund claims signal to the government that the taxpayer *may* have participated in an abusive transaction in order to generate a tax loss. All three models presented in Table 3, above, indicate that when the corporate taxpayer seeks a refund and when the IRS denies the refund claim, the government’s chances of winning increase by 34% to 42% at highly statistically significant levels. When numerous models produce consistent and significant findings, the results can be interpreted as robust and strongly probative of the variable’s effects on the outcome of interest. Our findings suggest that when corporate taxpayers seek the Court’s assistance in extracting money from the Treasury in a refund claim, the Justices are much more likely to find the transaction abusive than in cases in which the corporation simply seeks to pay less tax than the government deems owed.

c. Personnel Factor

Several scholars have suggested that Justice Scalia’s appointment led to an increase in judicial deference to the text of the tax statute, a literalist approach that often underlies taxpayers’ arguments in corporate tax abuse cases. Our models indicate that a corporation’s chance of winning increased between 1% and 9% in the post-1986 era. The negative sign on Justice Scalia’s coefficient in all three models presented in Table 3 indicates that Justice Scalia may have had an effect on the government’s win rate.

We cannot confidently conclude that Justice Scalia and the plain meaning approach to statutory interpretation has had the predicted impact for a few important reasons. First, the results are not statistically significant. Second, our dataset includes only a small number of judicial opinions—nine—in the time period under investigation. Third—and perhaps most problematic to the theory highlighting Justice Scalia’s role in tax abuse cases, the government’s probability of winning began to decline well before Scalia’s appointment, casting further doubt on the Scalia theory. Finally, the appointment of Justice Scalia in 1986 occurred during the same period as other significant developments in the federal tax law, namely the enactment of the Tax Reform Act of 1986, which may have had an effect on the Justices’ interpretation of tax avoidance strategies. It bears noting, however, that although the Supreme Court appears to have taken a pro-taxpayer turn in the late 1950s, the government’s probability of winning consistently exceeds the taxpayer’s probability of winning.

C. Historial Use of the Judicial Doctrines in US Supreme Court

We have focused on US Supreme Court decisionmaking over the course of the last century. Our findings therefore reflect statistical effects averaged over the course of many years. This raises the question: Are the decisions and outcomes rendered in the mid-1900s and earlier relevant for understanding the contemporary US Supreme Court? To begin, we note that we examined abuse cases over such a long period in order to obtain a sufficient number of observations to fit the data to the models.[[21]](#footnote-21) This technical explanation, of course, leaves the substantive question unanswered. Thus, we conducted a qualitative investigation of the early Court opinions to understand and explain how the docket, arguments, and legal analyses have changed over time. As we discuss below, to our surprise, we found high levels of consistency over the different eras.

We found that while the specific details of the transactions and tax positions have changed over the years, the government has consistently looked to the same five factors when identifying abuse. It has pointed to the presence of third parties in cases decided as early as 1913 and as late as 1991; to multistep transactions in cases decided as early as 1925 and as late as 1991; to the lack of a business purpose from 1920 through 1991; to accounting irregularities from 1925 through 2011; and to inappropriate refund requests from 1927 through 1991. These findings indicate that the taxpayers have altered the details of their avoidance strategies over the course of the last century, but they have also continually incorporated the same general attributes that have served as signals of abuse since 1913.

We also examined the Supreme Court’s opinions for purposes of understanding the transformations in precedent and legal analyses. This was necessary because even if the signals of abuse have remained constant, if the Court has updated and transformed its view of the five factors, then the early opinions may have very little relevance for understanding today’s decisionmaking process. Our qualitative investigation, however, indicates that early judicial opinions continue to affect later Courts. Consider *United States v. Hughes Properties, Inc.*, a 1986 case that involved accounting irregularities.[[22]](#footnote-22) The majority opinion cited to abuse cases decided in 1926, 1930, and 1961 in order to identify the fundamental principles of tax accounting.[[23]](#footnote-23) In *United Dominion Industries, Inc. v. United States*, a 2001 case in which the government argued that the taxpayer took a tax position that rose to the level of abuse,[[24]](#footnote-24) the Court also considered early cases such as *Woolford Realty Co. v. Rose* (decided in 1932)[[25]](#footnote-25) and *Libson Shops, Inc. v. Koehler* (decided in 1957).[[26]](#footnote-26) Indeed, one of the cases included in our study, *North American Oil Consolidated v. Burnet*,[[27]](#footnote-27)decided in 1932, has been cited over one hundred times in the post–World War II era, including in numerous Supreme Court corporate tax abuse cases.[[28]](#footnote-28)

The seventy-six judicial opinions addressing corporate tax abuse and issued between the years 1909 and 1945 have generated 9,863 citations—and more than half of these citations occur in the post–World War II era. Our qualitative analysis, in short, leads us to conclude that the corporate tax abuse opinions do not become antiquated, but rather serve as useful precedent for generations. Professor James Eustice noted that modern corporate tax abuse is “packaged in new and exotic wrappers,”[[29]](#footnote-29) but its basic elements are “still the same old, same old thing.”[[30]](#footnote-30) We would add that the cases also require the same old jurisprudential considerations.

III  
Shams in Other US Legal Contexts

This Chapter has investigated judicial decision making in the context of corporate tax shams, but allegations of sham-like behavior can be found in many other taxaton contexts. Indeed, sham transactions have emerged across the legal spectrum, and US courts have continually grappled with the question of how these transactions—consisentent with the letter of the law but not its purpose—should be treated.

The extant US scholarly literature is replete with examples of suspected sham transactions. In the constitutional context, public officials have attempted to avoid Constitutional anti-discrimination rules (applicable only to state actors) by selling assets, such as state hospitals, to private entities while apparently still retaining substantive control over properties.[[31]](#footnote-31) In antitrust disputes, courts have considered the problem of “sham litigation”—lawsuits brought solely to impose costs upon competitors in order to drive them from the market.[[32]](#footnote-32) In the trademark context, individuals and entities have sought to obtain trademark protection by satisfying the “sale of good requirement” by selling the item to a friend, a relative, or a controlled company rather than to an outside third party in an arm’s length transaction as the law appear to anticipate.[[33]](#footnote-33) In contract disputes, companies have sold property to a sister company at a ultra low prices in order to increase the observed damages associated with alleged losses associated with a breach of contract.[[34]](#footnote-34) In the enivornmental context, polluted and hazardous properties have been sold to penniless third persons in an effort to avoid environmental regulations rquireming owners to clean-up the property.[[35]](#footnote-35) In the securities context, companies have attempted to demonstrate profitability by engaging in intra-company sales in order to increase the recorded revenue from receipt of monies, monies that ulimately came from within the companies own cash reserves.[[36]](#footnote-36) This list represents just a small sampling of the many examples of sham transactions that occur in the US.

Moreover, just as in the corporate tax context, these sham transactions are all designed to exploit the letter of the law in order to achieve outcomes that appear at odds with the purpose of the underlying law. Throughout history, and in virtually every area of the law, US courts have considered alleged sham transactions and have struggled with how to address them. More specifically, courts must routinely decide whether they should respect the transaction alleged to be a sham or whether they should unwind the transaction, thereby denying the parties their preferred results. As in the corporate tax law, courts have failed to articulate a a clear and uniform approach for deciding whether particular arrangements and devices are shams. We leave for another day the question of whether factors similar to those that have affect judicial outcomes in corporate tax abuse cases similarly influence judges considering sham controversies in other legal contexts.

Conclusion

Allegations of sham-like behavior exist in every legal context and in jurisdictions across the world. In this Chapter, we focused on one particular area—coporatate tax shams in the US—and found that the US Supreme Court continually looks to certain factors when determining whether a the taxpayer has engaged in a abuse. Moreover, and unlike courts in many other coutries, the US Supreme Court decides the majority of the abuse controversies in favor of the government and against the corporation seeking to deploy ingenious strategies that adhere to the letter of the law but not its purpose. In identifying these trends, this study helps to identify when and why the US Supreme Court determines that ostensibly legal behavior has shaded into abuse and fraud. Empirical studies in various other sham contexts might highlight similar heretofor unidentified trends in US judicial decision making, thereby shedding light on an area of the law that has long be plagued with confusion and seemingly erratic outcomes. In coutries, such as Canada, New Zealand, and Australia, empirical studies of alleged sham transactions might illuminate the factors that convince courts to unwind a transaction—in the rare circumstances in which such a decision is rendered.

1. Nancy Staudt is the Edward G. Lewis Chair in Law and Public Policy and the Academic Director of the Schwarzenegger Institute at USC. Joshua Blank is a Professor of Tax Practice and Faculty Director of the NYU Graduate Program on Taxation. This chapter is excerpted with permission from Joshua D. Blank & Nancy Staudt, *Corporate Shams*, 87 N.Y.U. L. Rev. 1641 (2012). [↑](#footnote-ref-1)
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3. Timothy Hall, *Denial of social security retirement benefits to member of family business on ground that retirement was sham designed to qualify for benefits*, 102 A.L.R. 25 (1991) [↑](#footnote-ref-3)
4. Shu-Yi Oei, *Context Matters: The Recharacterization of Leases in the Bankruptcy and Tax Law,* 82 Am. Bankr. LJ. 635 (2008). [↑](#footnote-ref-4)
5. Comment, *Defining the “Sham Litigation” Exception to the Noerr-Pennington Antitrust Immunity Doctrine: An Analysis of the Professional Real Estate Investors v. Columbia Pictures Industries Decision,* 46 Ala. L. Rev. 815 (1995). [↑](#footnote-ref-5)
6. A.C.L. Davis, *Sensible Thinking about Sham Transactions,* 38 Indus. L.J. 318 (2009); Miranda Stewart, *What is the Point of the Doctrine of Sham,* [chapter in the book]. [↑](#footnote-ref-6)
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8. Treas. Reg. § 1.6011-4(e) (as amended in 2007). [↑](#footnote-ref-8)
9. *See Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties*, IRS.gov, http://www.irs.gov/Businesses/Guidance-for-Examiners-and-Managers-on-the-Codified-Economic-Substance-Doctrine-and-Related-Penalties (last updated Aug. 4, 2012) [hereinafter *Guidance for Examiners and Managers*]. [↑](#footnote-ref-9)
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15. See generally, The Honorable Justice Michael Kirby, Of “Sham” and Other Lessons for Australian Revenue Law, 32 Melbourne U. L.Rev 27 (2008). [↑](#footnote-ref-15)
16. Marvin A. Chirelstein & Lawrence A. Zelenak, Essay, *Tax Shelters and the Search for a Silver Bullet*, 105 Colum. L. Rev. 1939 (2005) [↑](#footnote-ref-16)
17. For a more detailed discussion of model interpretation, see Joshua D. Blank & Nancy Staudt, *Corporate Shams*, 87 N.Y.U. L. Rev. \_\_ (2012). [↑](#footnote-ref-17)
18. Cite the literature that Miranda sent. [↑](#footnote-ref-18)
19. We were unable to examine all three variables simultaneously due to the small number of cases in our dataset. [↑](#footnote-ref-19)
20. For a more nuanced interpretation of the interaction effects, see Joshua D. Blank & Nancy Staudt, *Corporate Shams*, 87 N.Y.U. L. Rev. \_\_ (2012). [↑](#footnote-ref-20)
21. We identified 137 tax abuse cases using the methodology described above.The Supreme Court decided ninety-three of these cases prior to 1950, leaving only forty-four to analyze with our models in the post-1950 era. When we attempted to do this with STATA, we found the model dropped numerous variables and produced unintelligible results. [↑](#footnote-ref-21)
22. 476 U.S. 593, 595 (1986). [↑](#footnote-ref-22)
23. The Court, for example, cited to *United States v. Anderson*, 269 U.S. 422, 441 (1926); *Lucas v. Kansas City Structural Steel*, 281 U.S. 264, 269 (1930), and also noted *United States v. Consolidated Edison Co. of New York*, 366 U.S. 380, 385 (1961). *Hughes Properties*, 476 U.S. at 600, 603 (1986). [↑](#footnote-ref-23)
24. 532 U.S. 822, 837 (2001). [↑](#footnote-ref-24)
25. *Id.* at 840, 842 (Stevens, J., dissenting) (citing Woolford Realty Co. v. Rose, 286 U.S. 319, 328, 330 (1932)). [↑](#footnote-ref-25)
26. *United Dominion*, 532 U.S. at 825 (citing Lisbon Shops, Inc. v. Koehler, 353 U.S. 382, 386 (1957)). [↑](#footnote-ref-26)
27. 286 U.S. 417 (1932). [↑](#footnote-ref-27)
28. *See, e.g.*, Comm’r v. Indianapolis Power & Light Co., 493 U.S. 203, 209 (1990); Am. Auto. Ass’n v. United States, 367 U.S. 687, 700 (1961) (Stewart, J., dissenting). [↑](#footnote-ref-28)
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30. *Id.* [↑](#footnote-ref-30)
31. Angela M Diveley, *Clarifying State Action Immunity Under the Anti-Trust Law: FTC v. Phoebe Putney Health System, Inc.,*  [↑](#footnote-ref-31)
32. Comment, *Defining the “Sham Litigation” Exception to the Noerr-Pennington Antitrust Immunity Doctrine: An Analysis of the Professional Real Estate Investors v. Columbia Pictures Industries Decision,* 46 Ala. L. Rev. 815 (1995). [↑](#footnote-ref-32)
33. Brian G. Gilpin, *Trademarks in Cyberspace: Fulfilling the "Use" Requirement Through the*

    *Internet,* 78 J. Pat. & Trademark Off. Soc'y 830 1996 [↑](#footnote-ref-33)
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36. James C. Dugan and Todd G. Cosenza, *The Future of Secondary Actor Liability Under Rule 10(B)-5 After Stoner DGE Investment Partners, LLC v. Cientific-Atlanta, Inc.,* 5 N.Y.U. J. L. & Bus. 793 2009.  [↑](#footnote-ref-36)