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Recent Developments: Jersey Shore State Bank v. United States: IRS Not Required to Provide Notice and a Demand for Payment to a Third-Party Lender Prior to Initiating a Civil Suit to Collect Employment Taxes

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proceedings. The court of appeals' rationale was that the exclusionary rule's additional deterrent effect would be insignificant or is greatly outweighed by its detrimental effect. However, the court therein concluded that if it can be shown that the illegally obtained evidence provided an incentive for the illegal seizure, the exclusionary rule would then apply. Such incentive would be evidenced by proof that seizure of the evidence was motivated by the possibility of enhancing the accused's sentence. *See Logan*, 289 Md. at 486 and *Lee*, 540 F.2d at 1212.

The court in *Chase* also analyzed how evidence falling under this category is handled in probation revocation proceedings nationwide. Although the court noted semantical differences in the various approaches, it found that the prevailing approach applied is the "cost/benefit analysis". "A probation revocation proceeding is not a criminal prosecution but is more in the nature of an administrative hearing intimately concerned with the probationer's rehabilitation. Thus, the court must balance the competing interests of the community with the rehabilitative goal of probation." *Chase*, 68 Md. App. at 422, 511 A.2d 1128. In light of this standard, the court concluded that the exclusionary rule generally did not apply to probation revocation proceedings. Combining Maryland case law with the semantical variations that exist nationwide, the court then incorporated a good faith exception into their newly adopted rule. In discussing their standard, Judge Wilner wrote:

> We agree, as a general proposition, that the deterrent effect of such an application [of the exclusionary rule] will be minimal and that whatever marginal deterrent benefit might accrue would be far outweighed by the harmful effect of denying access to relevant information concerning a probationer's behavior. . . . [Nevertheless], [w]e cannot permit the police to use this as an incentive to violate the Fourth Amendment. . . . [W]e think the best way to deter individual violations is simply to apply the exclusionary rule upon a showing that the police did not act in good faith in effecting the search and seizure. The "good faith" standard . . . encompasses all aspects of the officer's actions—how egregious the violation was, whether the officer knew the person was on probation . . . , what the circumstances were that led to the seizure.

Chase, 68 Md. App. at 425, 426, 511 A.2d 1128.

In concluding their discussion of the "good faith" exception, the court held that the burden is on the defendant initially to produce lack of good faith. Upon this production, the burden then shifts to the State to prove otherwise.

At the time of publication this case was set for argument before the Court of Appeals of Maryland. Although the court of appeals granted certiorari, it is doubtful that the case will be reversed because the court of special appeals' reasoning follows the national trend. *Chase* should help in lessening the frustration the law enforcement community feels in their pursuit of justice and community protection. It remains to be seen whether their pursuit will become a reality.

—Christopher Hale

Jersey Shore State Bank v. United States: IRS *NOT* REQUIRED TO PROVIDE NOTICE AND A DEMAND FOR PAYMENT TO A THIRD-PARTY LENDER PRIOR TO INITIATING A CIVIL SUIT TO COLLECT EMPLOYMENT TAXES

In *Jersey Shore State Bank v. United States*, 479 U.S. ____, 87-1 U.S.T.C. para. 9131 (1987), the Supreme Court in a unanimous decision held that the IRS was not required to provide notice and a demand for payment to a third-party lender who is liable under I.R.C. § 3505 prior to initiating a civil suit to collect employment taxes. This decision resolved a conflict between the circuits and is consistent with the interpretation of the Third and Ninth circuits.

The Supreme Court in *Jersey Shore State Bank* considered the relationship between I.R.C. § 3505 (which provides for personal liability on the part of third parties paying or providing funds for wages) and I.R.C. § 6303(a) (which requires that notice of an assessment be provided to persons liable for unpaid taxes before an assignment can be imposed). In rejecting the bank's claim that the government was required under I.R.C. § 6303(a) to provide notice and demand for payment to a lender bank that is liable under I.R.C. § 3505, the Court determined that a third-party lender is not the "person" intended to be protected under I.R.C. § 6303(a).

I.R.C. § 3505 applies to a third-party lender, surety or other person who is not an employer, but who pays wages either directly to that employee or group of employees, or supplies the funds to pay those employees. I.R.C. § 3505(a) imposes liability on those lenders, sureties or persons for a sum equal to any unpaid withholding taxes and interest if the wages were paid directly to the employee. However, under I.R.C. § 3505(b), if they did not pay the employees directly, but provided the funds to the employer, their liability would be limited to 25% of the amount of the loan. Prior to this section's enactment in 1966, the employers were the only individuals subject to liability.

I.R.C. § 3505 was enacted in order to correct problems which occurred when employers obtained net payroll financing. *United States v. Jersey Shore State Bank*, 781 F.2d 974, 976 (3d Cir. 1986). Net payroll financing, used frequently in the construction industry, is a practice whereby the lender provides funds for payment of employees' net wages, but not for payment of withholding taxes. This type of financing usually results when a financially strapped sub-contractor cannot meet its payroll obligations. The general contractor will then pay the sub-contractor's employees' net wages. Problems arise when the sub-contractor is unable to pay withholding taxes to the government while the government is required to credit the employees account. In such cases "[r]ecourse against the employer [is] often fruitless, because it [is] frequently without any financial resources. And the government could not proceed against third parties who paid the net wages because they were not 'employers' under the code, and therefore not liable for the taxes." *United States v. Jersey Shore State Bank*, 781 F.2d 974, 976 (3d Cir. 1986).

In the current case, Jersey Shore State Bank provided net payroll financing to Pennmount Industries, Inc., from the fourth quarter of 1977 through the first quarter of 1980. The government in its complaint alleged that Jersey Shore paid wages directly to Pennmount employees and supplied funds for the purpose of paying wages, *with the knowledge* that Pennmount did not intend to or would not be able to make timely payments or deposits of the federal taxes required to be deducted and withheld. The complaint also alleges that the Bank's liability is $76,547.57 plus interest under I.R.C. § 3505(a), and $72,069.00 plus interest under I.R.C. § 3505(b). The district court granted the bank's motion for summary judgment because of the government's failure to provide timely notice as required by I.R.C. § 6303(a). The United States appealed and the third circuit reversed. In examining the legislative history of the statute, the third circuit concluded that 6303(a) did not apply to collection actions under 3505 because 6303(a) was intended to protect taxpayers from harsh administrative collection procedures. The court noted, however, that under I.R.C. § 3505, the third-party lender was not in danger of having any of its property seized or attached to

satisfy the obligation as did an employer under § 6303(a). The court observed that "[i]n a civil action service of the government's complaint provides the [third-party lender] with all the notice required. . . ." 781 F.2d 974 at 981 (3d Cir. 1986).

Jersey Shore, dissatisfied with the court's ruling, petitioned the Supreme Court for a writ of certiorari. The Court granted the writ in order to resolve the inter-circuit conflict. The Court then went on to affirm the decision of the Third Circuit.

Chief Justice Rehnquist, writing for the Court, observed that there are three grounds for demonstrating a lack of connection between § 6303(a) and § 3505. First, I.R.C. § 3505 does not declare that a *lender* is "liable for unpaid taxes" which would give rise to the I.R.C. § 6303(a) notice requirement. Rather, a lender's liability under § 3505 only arises if it pays wages directly to an employee or supplies funds for the wages with *actual notice* or *knowledge* that the employer is either unable to make timely payment of the withholding taxes or has no intention of doing so. The Court found that a third-party lender is deemed to have such actual notice or knowledge from the time – in the exercise of due diligence – the lender would have been aware that the employer would not or could not make timely payments. "[A] prudent lender could be alerted to its liability under section 3505 at the time it engaged in what the government describes as net payroll financing. . . ." *Id.* at 87,115 (1987). Furthermore, the Court noted that, "[S]ureties can protect themselves against any losses attributable to withholding taxes by including this risk of liability in establishing their premiums, and lenders by including the amounts in their loans and taking adequate security." Citing, S. Rep. No. 1708, 89th Cong., 2d Sess., 23 (1966); H.R. Rep. No. 1884, 89th Cong., 2d Sess., 22 (1966).

Secondly, the Court considered the fact that employers and lenders are in different positions. While employers are subject to the government's summary collection procedures soon after unpaid employment taxes are assessed, the government may only forcibly collect against a lender by filing a civil suit in court. Thus, an employer has a far greater need for an assessment notice than a third-party lender who is not subject to summary collection procedures.

Lastly, the Court considered the actual content of the § 6303(a) notice. Under this section, the government must not only give notice to each person liable for unpaid tax but the notice must contain 1) the amount assessed and 2) the demand for payment. The Court pointed out that a third-party lender generally will not be concerned with the amount assessed because it may include the *employer's* share of the unpaid Social Security taxes for which the lender is not liable. *See*, H.R. Rep. No. 1884, 89th Cong., 2d Sess., 21 (1966). Thus, the notice required under § 6303(a) is likely to demand payment for an amount different from that for which the lender is liable.

This ruling by the Supreme Court makes clear that any lender who engages in net payroll financing is subject to suit, without the notice provided under 6303(a), if the employer fails to pay or deposit the required withholding taxes and the lender can be said to have actual notice or knowledge that the employer is not making timely withholding taxes.

– Robert R. Tousey

Kuykendall v. Top Notch Laminates, Inc.: MARYLAND REFUSES TO MAKE EMPLOYERS LIABLE FOR INJURIES CAUSED BY EMPLOYEES WHO BECAME INTOXICATED AT THEIR OFFICE PARTIES

In *Kuykendall v. Top Notch Laminates, Inc.*, No. 711 (Md. App. filed Feb. 9, 1987), the Court of Special Appeals of Maryland, affirmed the dismissal from the Circuit Court for Montgomery County, by holding that an employer who allegedly served alcohol to an employee at a party, who later crashed his car into an automobile, was not liable for his employee's actions.

Because the case was dismissed below, under Maryland Rule 2-322(2), the factual allegations advanced to Court of Special Appeals of Maryland were taken directly from the complaint, averring that Evelyn Hargis was killed instantly when the vehicle she was driving was struck head-on on December 23, 1985. Ms. Hargis was survived by her husband Jesse W. Kuykendall, and a minor daughter, Christina. The complaint stated that Charles E. Wilkes, Jr. and Robert Dean Wade, employees of Top Notch Laminates, Inc. (Top Notch), "were driving their separate cars while drunk." According to the allegations contained in the complaint, Wilkes and Wade were "swerving back and forth on the roadway trying to pass or to prevent the other from passing." During their "horse-play", Wilkes "swerved across the center line at a high rate of speed directly into the path of the car driven by Ms. Hargis." (slip op. at p. 1).

Immediately prior to this occurrence both Wilkes and Wade had been attending a Christmas party hosted by their employer Top Notch, attendance to which *was not required.* (Emphasis supplied). The complaint averred that Wilkes and Wade had been drinking "constantly from 12:30 p.m. to 5:00 p.m. and became highly intoxicated." The complaint further indicated that Top Notch knew of their intoxicated condition, but continued to serve both men alcoholic beverages. (*Id.* slip op. at 2). From these facts Mr. Kuykendall filed suit against Top Notch, for himself, as personal representative of Ms. Hargis' estate, and for the couple's minor daughter, Christina (Appellants). The Circuit Court for Montgomery County granted Top Notch's motion to dismiss, with which this appeal ensued.

On appeal, the court of special appeals was presented with the question of whether the employer could be held accountable for the actions of Wade and Wilkes, under traditional theories of negligence. As a preliminary matter, the court reviewed the elements of a negligence cause of action, (1) a legal duty, (2) a failure to perform the duty, (3) damage to the plaintiff, and (4) the damage occasioned by the defendant's failure to perform the duty. The appellants first argued that the legal duty owed by Top Notch was established because of the "special relationship" established between employer and employee. The appellants theory was based upon the *Restatement (Second) of Torts*, 315, which provides:

> "There is no duty so to control the conduct of a third person as to prevent him from causing physical harm to another unless
>
> (a) a *special relation* exists between the actor and the third person which imposes a duty upon the actor to control the third person's conduct, or
>
> (b) a *special relation* exists between the actor and the other which gives to the other a right to protection." (Emphasis added). *Id.* slip op. at 6.

The appellants alleged that this relationship "conferred a duty upon Top Notch (the actor) to control the actions of Wilkes (the third person), as well as a duty to the general public to protect them from injury by Wilkes." (*Id.* slip op. at 6). This duty, appellants argued, was then breached when Top Notch permitted Wilkes and Wade to drive their own cars, because Top Notch chose not to prevent the two men from driving home while intoxicated.

Appellants' second argument was that the employer failed to exercise reasonable care to avoid injury to third persons, thereby relying on *Otis Engineering Corp. v. Clark*, 668 S.W.2d 307 (1983). In *Otis*, the Texas Supreme Court decided that, "an employer who knew his employee was incapacitated