

10-1-1978

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Recommended Citation

Saul L. Moskowitz, *Bankruptcy Law -- The Continued Vitality of the Six-Months Rule in Railroad Receiverships*, 57 N.C. L. REV. 137 (1978).Available at: <http://scholarship.law.unc.edu/nclr/vol57/iss1/6>

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NOTES

Bankruptcy Law—The Continued Vitality of the Six-Months Rule in Railroad Receiverships

One hundred years have passed since the United States Supreme Court in *Fosdick v. Schall*¹ first set forth the six-months rule for establishing creditors' priorities in railroad receiverships. The rule, as pronounced by the *Fosdick* Court and amplified in subsequent decisions, gives priority in payment to unsecured creditors who, within a period of six months prior to the initiation of reorganization proceedings,² supply materials or services necessary to the continued operation of the railroad.³ In recent years the rule has been in issue in litigation arising out of receiverships involving the Penn Central Transportation Company,⁴ the New York, New Haven and Hartford Railroad Company,⁵ and the Tennessee Central Railway Company.⁶ In the ongoing Penn Central reorganization, for example, claims under the six-months rule total some \$62.5 million.⁷

Despite its continuing importance, the six-months rule has been inconsistently applied during its century of development.⁸ The courts,

1. 99 U.S. 235 (1878).

2. The rule is applicable in appropriate railroad reorganization proceedings by virtue of section 77(b) of the Bankruptcy Act, 11 U.S.C. § 205(b) (1970), which provides:

For all purposes of this section unsecured claims, which would have been entitled to priority if a receiver in equity of the property of the debtor had been appointed by a Federal court on the day of the approval of the petition, shall be entitled to such priority and the holders of such claims shall be treated as a separate class or classes of creditors.

3. Although the Supreme Court has never applied the rule outside the railroad receivership context, the lower federal courts have employed the rule in cases involving public or quasi-public corporations. 6 COLLIER ON BANKRUPTCY ¶ 9.13[5], at 1633 (14th ed. J. Moore 1978); see, e.g., *In re Madison Ry.*, 115 F.2d 586 (7th Cir. 1940); *Crane Co. v. Fidelity Trust Co.*, 238 F. 693 (9th Cir. 1916), cert. denied, 244 U.S. 658 (1917); *Louisville & N.R.R. v. Memphis Gaslight Co.*, 125 F. 97 (6th Cir. 1903).

4. See *In re Penn Cent. Transp. Co.*, No. 70-347 (E.D. Pa., filed June 21, 1970).

5. See *In re New York, N.H. & H.R.R.*, 278 F. Supp. 592 (D. Conn. 1967), aff'd, 405 F.2d 50 (2d Cir. 1968), cert. denied, 394 U.S. 999 (1969).

6. See *In re Tennessee Cent. Ry.*, 316 F. Supp. 1103 (M.D. Tenn. 1970), vacated on other grounds, 463 F.2d 73 (6th Cir.), cert. denied, 409 U.S. 893 (1972).

7. Affidavit of Aidan Mullett at 11, *In re Penn Cent. Transp. Co.*, No. 70-347 (E.D. Pa., filed June 20, 1970).

8. See *In re Third Ave. Transit Corp.*, 138 F. Supp. 623 (S.D.N.Y. 1955), aff'd per curiam, 230 F.2d 425 (2d Cir. 1956), where the court stated: "The researches of counsel supplemented by such research as has been at my command have not resulted in the discovery of any principle which would account for all of the decisions or even enough of the decisions so that one might say there was a principle behind them." *Id.* at 625.

particularly in recent years, have frequently applied the rule mechanically, without sufficiently analyzing the particular questions before them in relation to the underlying rationale of the rule. This has created confusion concerning the application of the rule and resulted in a number of issues that are in need of resolution.

THE DEVELOPMENT OF THE RULE

The six-months rule is an equitable doctrine that first appeared in a federal equity receivership,⁹ *Fosdick v. Schall*. In that case the Supreme Court recognized that the business of all railroad companies is done, to a greater or lesser extent, on credit.¹⁰ When railroad companies encounter financial difficulties, current debts for labor, supplies and equipment are often allowed to accumulate so that mortgage payments may be made and a foreclosure postponed, if not avoided.¹¹ The Court found this process to be inequitable because: "Every railroad mortgagee in accepting his security impliedly agrees that the current debts made in the ordinary course of business shall be paid from the current receipts before he has any claim upon the income."¹² The Supreme Court went on to hold that claims of prereceivership operations creditors¹³ were entitled to priority with respect to receivership income, even though that income was subject to the lien of the railroad's underlying mortgage if, during or immediately prior to the receivership, income had been diverted to the benefit of the mortgagees.¹⁴ Equity required that the mortgagees restore any such "diversions" to the "current debt fund."¹⁵ The Court reasoned that every railroad mortgagee impliedly agrees that current debts shall be paid first from current receipts, because without operating creditors no income at all

9. The federal equity receivership was the precursor of the reorganization procedures now applied under section 77 of the Bankruptcy Act, 11 U.S.C. § 205 (1970). Generally, a creditor of a financially distressed railroad would file a creditor's bill in federal court asking that a receivership of the property of the debtor be instituted. Once the receivership was commenced, the debtor was protected from the attacks of subsequent creditors, and its business was continued under the control of the receiver in order that all debts might be paid in an orderly fashion. The formal function of the receivership was ended when the property of the debtor was sold by the court to pay, to the extent possible, the claims of the creditors. See generally COLLIER ON BANKRUPTCY, *supra* note 3, ¶ 0.04.

10. 99 U.S. at 252.

11. *Id.*

12. *Id.*

13. An "operations creditor" may be defined as an unsecured creditor who supplied labor or materials necessary to the continued operation of the railroad. See COLLIER ON BANKRUPTCY, *supra* note 3, ¶ 9.13[5], at 1635 & n.38.

14. 99 U.S. at 252-53.

15. *Id.*

would be produced and the value of the mortgage would be considerably undermined.¹⁶

In *Burnham v. Bowen*,¹⁷ the Supreme Court expanded upon the *Fosdick* doctrine, declaring that current income itself, whether collected prior to or during the receivership and regardless of diversions, was encumbered by current debts arising out of the operations of the railroad that produced the income.¹⁸ Thus, the Court held that current debts should be paid first, out of either prereceivership or receivership income.¹⁹ The *Burnham* Court also held that if diversions to the benefit of the mortgagees from current income occurred, the current creditor could have resort to the corpus of the mortgaged property to the extent of the diversions.²⁰ Further, the current creditor could insist on a sale of the property to the extent of the diversions if he had not been paid.²¹

Despite the *Burnham* Court's expansion of the *Fosdick* rule, the Supreme Court did not intend to give current creditors an unqualified priority over mortgagees. In *Kneeland v. American Loan & Trust Co.*,²² the Court restricted the application of the six-months rule by emphasizing that the priority of mortgage liens over the corpus should ordinarily be displaced only when diversions had occurred.²³ The Court reprimanded those lower courts that had liberally allowed invasions of the corpus of mortgaged property in order to satisfy the claims of current creditors, stating: "[T]he appointment of a receiver vests in the court no absolute control over the property, and no general authority to displace vested liens. . . . It is the exception and not the rule that such priority of liens can be displaced."²⁴

16. See *Burnham v. Bowen*, 111 U.S. 776, 780 (1884).

17. 111 U.S. 776 (1884).

18. *Id.* at 780-81.

19. *Id.* at 782. See also *Virginia & Ala. Coal Co. v. Central R.R. & Banking Co.*, 170 U.S. 355, 365, 369 (1898). Receivership income is, however, first devoted to the expenses of the receivership. COLLIER ON BANKRUPTCY, *supra* note 3, ¶ 0.04, at 40.

20. 111 U.S. at 782.

21. *Id.* at 782-83. In a later case, *St. Louis, A. & T.H.R.R. v. Cleveland, C., C. & I. Ry.*, 125 U.S. 658 (1888), the Court explained that the current creditor must show as a condition precedent to its right to resort to the corpus that the diversion occurred after the railroad became indebted to it. *Id.* at 672.

22. 136 U.S. 89 (1890).

23. The priority of the mortgage lien may also be displaced through rare application of the necessity of payment rule. See note 30 *infra*. See also *Gregg v. Metropolitan Trust Co.*, 197 U.S. 183 (1905); *Miltnerberger v. Logansport Ry.*, 106 U.S. 286 (1882); *Moore v. Donahoo*, 217 F. 177 (9th Cir. 1914), *cert. denied*, 235 U.S. 706 (1915); *Carbon Fuel Co. v. Chicago, C. & L.R.R.*, 202 F. 172 (7th Cir. 1912).

24. 136 U.S. at 97-98.

In *Southern Railway v. Carnegie Steel Co.*,²⁵ the Supreme Court, after reviewing its earlier cases dealing with the current creditors' priority,²⁶ defined the class of creditors entitled to assert the priority as including only those creditors who supplied materials and services necessary to the operation of the railroad in reliance upon the current income of the railroad, as opposed to its general credit, for payment.²⁷ Thus, in *Southern Railway* the Court granted priority to a supplier of steel rails, while in *Lackawanna Iron & Coal Co. v. Farmers' Loan & Trust Co.*,²⁸ decided the same day as *Southern Railway*, the Court denied priority to another supplier of steel rails because the latter supplier had relied on the general credit rather than the current income of the railroad.²⁹

The Supreme Court's development of the six-months rule culminated in *Gregg v. Metropolitan Trust Co.*³⁰ In *Gregg*, a creditor who had supplied a small quantity of railroad ties shortly before receivership proceedings began sought to have his debt satisfied from the corpus of the estate. Although the Court recognized that the claimant had a valid equitable lien on current income in the hands of the receiver, it found that no such fund of surplus earnings existed.³¹ Moreover, the Court found that no diversions had occurred by which the mortgagees had profited.³² This finding affirmed the court of appeals' holding³³ that no diversion had occurred when payments on capital improvements and other expense items that benefited the mortgagees were more than matched by funds obtained by the railroad through borrowings and receipts not considered to be part of current railroad

25. 176 U.S. 257 (1900).

26. *Id.* at 273-86.

27. *Id.* at 286.

28. 176 U.S. 298 (1900).

29. *Id.* at 316-17. See also *Virginia & Ala. Coal Co. v. Central R.R. & Banking Co.*, 170 U.S. 355, 365 (1898).

30. 197 U.S. 183 (1905). The *Gregg* decision restricts the necessity of payment rule established in *Miltenberger v. Logansport Ry.*, 106 U.S. 286 (1882). The necessity of payment rule allows the receiver to make distributions to current creditors out of the corpus regardless of whether there have been any diversions to the benefit of the mortgagees. *Id.* at 312-13. *Gregg* limited this power to the extraordinary circumstance in which payment of the claim is indispensable to the business of the railroad, as when the claimant supplies essential and otherwise unobtainable materials and threatens to cut off the railroad's supply if not paid. 197 U.S. at 187. See, e.g., *Carbon Fuel Co. v. Chicago, C. & L.R.R.*, 202 F. 172, 174 (7th Cir. 1912).

31. 197 U.S. at 188; see *Gregg v. Metropolitan Trust Co.*, 124 F. 721, 721 (6th Cir. 1903), *aff'd*, 197 U.S. 183 (1905).

32. 197 U.S. at 186.

33. 124 F. 721 (6th Cir. 1903), *aff'd*, 197 U.S. 183 (1905).

income.³⁴ Accordingly, the Supreme Court denied any priority to the six-months claimant.³⁵

These early Supreme Court decisions clearly set out the broad framework of the six-months rule. The Court of Appeals for the Eighth Circuit, in a frequently cited passage from its opinion in *Guaranty Trust Co. v. Albia Coal Co.*,³⁶ reduced that framework to three requirements:

- (1) That the consideration for the claim was a current expense of ordinary operation of the railroad, necessarily incurred to keep it a going concern.
- (2) That the claim represents a debt contracted with the expectation or intention of the parties that it was to be paid out of the current earnings of the railroad.
- (3) That the claim shall have accrued within six months prior to the appointment of the receiver.³⁷

Within this broad framework, however, courts have varied considerably in their applications of the rule. In *Southern Railway* the Supreme Court recognized that its own cases failed to lay down any clearly definable or uniformly applied rule.³⁸ It is not surprising, then, that subsequent lower court decisions have left a number of issues unresolved.

THE EQUITABLE BASIS OF THE RULE

Several of the early Supreme Court decisions suggest that the basis in equity of the six-months priority is that the current creditors have protected the value of the mortgagees' security by keeping the railroad running.³⁹ Accordingly, the trustees of the Penn Central Transportation Company argue in that railroad's current reorganization proceeding that

34. *Id.* at 727.

35. *See* 197 U.S. at 189.

36. 36 F.2d 34 (8th Cir. 1929).

37. *Id.* at 35. The requirement that the claim have accrued within six months was not always strictly applied in the early cases. *See* *St. Louis & S.F.R.R. v. Spiller*, 274 U.S. 304, 311 (1927). The origin of the six month period as a limitation is unclear. *See, e.g.,* *Westinghouse Air Brake Co. v. Kansas City S. Ry.*, 137 F. 26 (8th Cir. 1905) (six month period needed to avoid secret liens); FitzGibbon, *The Present Status of the Six Months' Rule*, 34 COLUM. L. REV. 230, 240-41 (1934) (six months period borrowed from Illinois statute).

38. 176 U.S. at 285.

39. *See, e.g.,* *Union Trust Co. v. Illinois Midland Ry.*, 117 U.S. 434, 455 (1886); *Burnham v. Bowen*, 111 U.S. 776, 780 (1884); *Union Trust Co. v. Souther*, 107 U.S. 591, 594-95 (1882). *See also* *In re New York, N.H. & H.R.R.*, 405 F.2d 50, 52 (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969).

the six months' priority is premised upon the granting of some special benefit or enrichment by operations creditors in the six-month period prior to bankruptcy, and on the receiving of that benefit or enrichment by other creditors who therefore can be expected to bear the burden of compensatory special treatment for the operations creditors.⁴⁰

If, however, the continued operation of the railroad has served only to decrease the value of the mortgagees' security through extensive operating losses, the trustees conclude that there is no equitable reason to give priority to the six-months creditors over the mortgage liens.⁴¹

The trustees' analysis, however, fails to account for the cases that have refused to apply the six-months rule in reorganizations of private corporations other than railroads.⁴² As these cases illustrate, the basis of the rule is the significant public interest in the continued operation of the railroads.⁴³ In ordinary receiverships, the only interests at stake are those of the mortgagees and the various claimants; in railroad receiverships, the public's interest in continued railroad operation is paramount. Given the often tenuous financial condition of railroads, frequently complicated by a heavy mortgage burden,⁴⁴ it would in many cases be difficult for railroads to obtain the materials and labor necessary for operation if railroads offered only their general credit as security for operating creditors. Public policy therefore demands that these claimants be given assurances of payment in the event of a bankruptcy.

The Supreme Court's "implied agreement"⁴⁵ in *Fosdick v. Schall* is best seen as an unconvincing rationalization by the Court for its, at that time, novel derogation of the mortgage liens.⁴⁶ The equities of current creditors' claims are the same whether the corporation in receivership is of public or merely private concern; it is the public interest in the continued operation of the nation's railroads that justifies the six-months rule's unique reordering of receivership priorities.⁴⁷ Thus, the

40. Memorandum in Support of Trustees' Position with Respect to Six Months' Claims at 1, *In re Penn Cent. Transp. Co.*, No. 70-347 (E.D. Pa., filed June 20, 1970).

41. *Id.* at 2.

42. See *In re Pusey & Jones Corp.*, 295 F.2d 479, 480 (3d Cir. 1961). But see *Dudley v. Mealey*, 147 F.2d 268, 271 (2d Cir. 1945).

43. See, e.g., *Pennsylvania Steel Co. v. New York City Ry.*, 208 F. 168, 182 (S.D.N.Y. 1913), *aff'd*, 216 F. 458 (2d Cir. 1914), *cert. denied*, 238 U.S. 632 (1915). But see *Gregg v. Mercantile Trust Co.*, 109 F. 220, 227-28 (6th Cir. 1901).

44. See *In re Penn Cent. Transp. Co.*, No. 70-347 (E.D. Pa., filed June 20, 1970).

45. See text accompanying notes 9-16 *supra*.

46. See Wham, *Preference in Railroad Receiverships*, 23 ILL. L. REV. 141, 142-43 (1928).

47. Even when courts have considered the issue of benefit, they have often assumed that the

only equitable condition precedent for the application of the rule is that the materials or services provided by the claimant be necessary to the continued operation of the railroad.

CURRENT OPERATING EXPENSES

In order to qualify for the six-months priority, a claim must be based on a current expense arising from the ordinary operation of the railroad.⁴⁸ Materials and supplies directly associated with the operation of a railroad, such as rails or ties for normal track maintenance, fuel, power and normal replacements for worn-out equipment, along with the services associated with the provision of such materials, clearly qualify as current expenses.⁴⁹

Purchases of new equipment and new construction, as distinguished from repairs, however, do not fall within the preferred class of claims, no matter how imperative the need therefor.⁵⁰ The cases suggest that the distinction lies in whether additions to equipment are being made, and whether the repairs merely restore the damaged property or serve to improve its quality.⁵¹

If the justification for the six-months priority rests upon the public interest in the continued operation of the railroad, however, the test ought to be whether the expense was necessary and proximately related to the physical operation of the road. Thus, a supplier of new cars needed to replace aged, deteriorated cars should be entitled to the protection of the six-months priority. A railroad should not be forced by its search for credit to undertake stopgap repairs in lieu of buying new

continued operation of the railroad has benefited the value of the mortgagees' security. See, e.g., *In re Tennessee Cent. Ry.*, 316 F. Supp. 1103, 1113 (M.D. Tenn. 1970), *vacated on other grounds*, 463 F.2d 73 (6th Cir.), *cert. denied*, 409 U.S. 893 (1972). This assumption rests on the theory that a forced sale of a nonoperating railroad would obtain a reduced price as compared to a similar sale of an operating property. For example, the good will attendant to an operating railroad would presumably not be a factor in the sale of a railroad that had earlier ceased operations. Although this assumption has been criticized as unrealistic given the possibility of an early reorganization before the railroad's financial difficulties become so acute as to force the cessation of operations, see *In re New York, N.H. & H.R.R.*, 278 F. Supp. 592, 598 n.10 (D. Conn. 1967), *aff'd*, 405 F.2d 50 (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969), no court has yet rejected a six-months claim on the ground that the claimant produced no benefit to the mortgage creditors.

48. See FitzGibbon, *supra* note 37, at 235-38.

49. *Id.* Priority has been denied, however, to many items normally included in any accounting methodology as operating expenses. This category includes tort claims, see, e.g., *St. Louis Trust Co. v. Riley*, 70 F. 32 (8th Cir. 1895), debts for special legal services, the printing of time tables, and premium payments for general liability insurance. See FitzGibbon, *supra* note 37, at 236-37.

50. See *Lackawanna Iron & Coal Co. v. Farmers' Loan & Trust Co.*, 176 U.S. at 315.

51. See, e.g., *Crane Co. v. Fidelity Trust Co.*, 238 F. 693, 698 (9th Cir. 1916), *cert. denied*, 244 U.S. 658 (1917).

equipment. The six-months rule should, in any event, be strictly applied to avoid unnecessary invasions of the vested contract rights of railroad mortgagees.⁵² The courts ought to examine carefully whether the asserted expense was indeed necessary; the rule should not serve to subsidize the unwise expansion of a financially unstable railroad.

RELIANCE ON CURRENT OPERATING INCOME

As a further prerequisite for the six-months priority, a claimant must demonstrate reliance on the current operating income of the railroad for payment, as opposed to reliance on the general credit of the corporation.⁵³ The six-months rule is designed to allow the railroad to acquire materials and supplies that creditors would otherwise be reluctant to sell because of a lack of security. Thus, when a claimant relies on some form of security other than the generalized hope that railroad operations will generate sufficient income to pay current debts, it should not be entitled to the six-months priority. The claimant's reliance upon the railway's general credit is determined by reference to the amount of the debt, the time and terms of payment, and all other circumstances attending the transaction.⁵⁴ It is not necessary to provide direct evidence of the parties' expectation that the suppliers would be paid out of current earnings.⁵⁵

Reliance on current income is perhaps best defined by way of contrast, in terms of those factors that indicate a reliance upon the general credit of the railroad. When a claimant receives security, it is presumed that it relied upon the security and not upon current earnings.⁵⁶ Further, when payment is unreasonably deferred, it is presumed that reliance was based upon the long-term financial condition of the company.⁵⁷ Also, an unusually large expenditure, out of the ordinary course of business of the railroad, may indicate that the general credit of the railroad, rather than its current income, was relied upon.⁵⁸

52. See *Johnson Fare Box Co. v. Doyle*, 250 F.2d 656, 657 (2d Cir.) (per curiam), *cert. denied*, 357 U.S. 938 (1958); *Kneeland v. American Loan & Trust Co.*, 136 U.S. at 97-98.

53. See, e.g., *Lackawanna Iron & Coal Co. v. Farmers' Loan & Trust Co.*, 176 U.S. at 316-17.

54. *Southern Ry. v. Carnegie Steel Co.*, 176 U.S. at 285.

55. *Pennsylvania Steel Co. v. New York City Ry.*, 216 F. 458, 471 (2d Cir. 1914), *cert. denied*, 238 U.S. 632 (1915).

56. See *Thomas v. Western Car Co.*, 149 U.S. 95, 112 (1893).

57. E.g., *Bound v. South Carolina Ry.*, 58 F. 473, 480-81 (4th Cir. 1893) (payment deferred for eight months).

58. E.g., *Rodger Ballast Car Co. v. Omaha, K.C. & E.R.R.*, 154 F. 629, 633 (8th Cir. 1907).

It is not fatal to a current creditor's six-months claim, however, to have taken the notes of the railroad debtor. In *Southern Railway* the Supreme Court, emphasizing the small quantity of materials supplied in that case and the short credit terms of the transaction, granted priority to a six-months claimant even though the claimant took the debtor's promissory note. As the Court recognized, the use of the notes merely showed that the creditor preferred to have its debt evidenced by negotiable commercial paper rather than to stand on open account.⁵⁹

THE CURRENT DEBT FUND

The six-months priority attaches first to the current debt fund, also known as the current expense fund.⁶⁰ Surprisingly, in the one hundred years during which case law concerning the six-months rule has developed, only one court has sought to define the current debt fund.⁶¹ In *In re New York, New Haven & Hartford Railroad*,⁶² the Court of Appeals for the Second Circuit stated:

We hold that the availability of a current expense fund under the six-months rule is to be determined by generally accepted accounting practices, including those prescribed by the Interstate Commerce Commission, and that under those practices the current expense fund is to be computed by deducting operating expenses and depreciation from operating revenues.⁶³

The Interstate Commerce Commission Annual Reports and generally accepted accounting practices, upon which the *New Haven* court relied in defining the current debt fund,⁶⁴ are based on accrual accounting

59. 176 U.S. at 290.

60. See *Guaranty Trust Co. v. Albia Coal Co.*, 36 F.2d at 35. In theory, the priority could attach first to the unmortgaged property of the railroad. See *Pennsylvania Steel Co. v. New York City Ry.*, 208 F.168 (S.D.N.Y. 1913), *aff'd*, 216 F. 458 (2d Cir. 1914), *cert. denied*, 238 U.S. 632 (1915). It is unlikely, however, that the modern railroad forced into reorganization will have any unmortgaged assets. It certainly will not have unmortgaged assets sufficient to satisfy all its six-months creditors. See *In re Penn Cent. Transp. Co.*, No. 70-347 (E.D. Pa., filed June 20, 1970).

61. Many of the cases speak of the income available to satisfy the six-months claims and the corpus, to the extent that it may be invaded by the six-months creditors, as together constituting the current debt fund. See, e.g., *In re New York, N.H. & H.R.R.*, 405 F.2d 50, 52 (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969). In this Note, however, the two sources of funds will be discussed separately. In this section, the focus will be on determining the existence of an income fund.

62. 405 F.2d 50 (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969).

63. *Id.* at 52.

64. The Supreme Court has used a variety of terms in referring to the current debt fund: net earnings, *Southern Ry. v. Carnegie Steel Co.*, 176 U.S. at 285; income, *Virginia & Ala. Coal Co. v. Central R.R. & Banking Co.*, 170 U.S. 355, 368 (1898); surplus earnings, *Kneeland v. American Loan & Trust Co.*, 136 U.S. at 96; current income, *St. Louis, A. & T.R.R. v. Cleveland, C., C. & I. Ry.*, 125 U.S. 658, 673 (1888); current earnings, *Burnham v. Bowen*, 111 U.S. at 780; and current

principles. Accrual accounting reflects receivables and expenses as they are earned or owed, rather than as they are paid.⁶⁵ Thus, the accrual accounting system reflects the actual financial position of the railroad over an extended period of time.

The six-months claimant is, by definition, a short-term creditor; he does not look to the complete, actual financial position of the debtor railroad but to something more akin to its short-term cash flow position. The accrual accounting method, therefore, unduly penalizes six-months creditors. If the existence of a current debt fund is determined by accrual accounting methods, the fund to which the priority of six-months claimants may attach will be reduced by the amount of their claims even though those debts have not yet been paid. This occurs because, in order to reach net income, expenses are deducted from revenues as those expenses are incurred, not as they are paid.

In rejecting the argument that accrual accounting principles should not apply in determining the availability of a current debt fund, the court in *New Haven* stated that the six-months creditors, at the time they supplied the materials or services to the debtor railroad, had no right to expect that accrued expenses would not be paid.⁶⁶ The six-months creditors, however, might well expect that their claims would be given priority over all other unpaid debts and "paper" expenses in the current income of the railroad.⁶⁷ Certainly, the inclusion of paper transactions such as depreciation in the calculation of expenses exacerbates the failure to reflect properly the nature of the six-months rule. Since the six-months creditor must rely upon the railroad's short-term ability to pay its current debts, the reduction of the current expense fund by a noncash item such as depreciation, which does not directly impair the railroad's short-term cash or current receipts position, is improper.

receipts, *Fosdick v. Schall*, 99 U.S. at 252. These terms do not, however, adequately define the accounting basis for determining whether a current debt fund exists.

In *In re New Hope & Ivyland R.R.*, 353 F. Supp. 608, 611 (E.D. Pa. 1973), the court defined current income as the "excess of current receipts over current expenses." This does not, however, establish whether an accrual or a cash method of accounting should be used or what expenses should be considered current expenses. It was not necessary for the court in *New Hope* to reach these issues because it denied the six-months priority on the ground that the railroad was acquiring a capital asset.

65. H. FINNEY & H. MILLER, *PRINCIPLES OF FINANCIAL ACCOUNTING* 89 (1968).

66. 405 F.2d at 52.

67. *Cf. Thomas v. Western Car Co.*, 149 U.S. 95 (1893) (six-months claimants must rely "upon the interposition of a court of equity").

It would be erroneous, however, to say that the current debt fund should be defined simply as the cash and current receipts of the railroad. That definition does not recognize that the six-months priority can only attach to cash and current receipts *on hand*—the six-months rule makes no provision for the return of monies already paid out to other current creditors. To define the current debt fund, therefore, as the *total* of the railroad's cash and current receipts during the applicable period is to overvalue the fund. The current debt fund is better defined as the cash and current receipts on hand to pay current debts. This definition is supported by a statement of the Supreme Court in *Gregg*: "It is agreed that the petitioner may have a claim against surplus earnings, if any, in the hands of the receiver" ⁶⁸ The *Gregg* Court thus seemed to imply that the current debt fund to which the six-months claimant has priority consists of the earnings on hand, rather than the net financial position of the railroad. ⁶⁹

INVASIONS OF CORPUS

Assuming that the current debt fund, however defined, is insufficient to satisfy all the six-months claims, the six-months creditors may, in certain circumstances, look to the corpus of the mortgaged property. The general rule as to invasions of the corpus in order to pay properly qualified six-months claims was firmly established by the Supreme Court in *Gregg*, in which the Court held that the corpus of the mortgaged property could ordinarily be charged with the six-months claims only if, and to the extent that, there had been diversions from income to the benefit of the mortgagees. ⁷⁰

The Supreme Court had earlier defined "diversion" as the payment of mortgage interest, the purchase of new equipment, or the acquisition of valuable additions out of the earnings which ought, in

68. 197 U.S. at 183.

69. In terms of generally accepted accounting principles, perhaps the closest analog to the suggested definition would be the statement of changes in financial position, which reflects working capital flow. See J. SMITH & K. SKOUSEN, *INTERMEDIATE ACCOUNTING* 680, 684 (1977). This statement is of primary importance to the short-term creditor as it reveals the financial resources that will be available within a short period of time for debt payment. R. SCHATTKER, H. JENSEN & V. BEAN, *FINANCIAL ACCOUNTING* 12 (1974). Funds from borrowings should be excluded from any definition of current debt fund in that they do not represent earnings or income from the operations of the railroad.

70. 197 U.S. at 186-87. The corpus may also be invaded in order to pay current creditors under the necessity of payment rule. See note 30 *supra*. It is clear that the necessity of payment rule can have no relevance after the railroad has ceased operations, as is the case in the current Penn Central proceedings. See *Moore v. Donahoe*, 217 F. 177, 182 (9th Cir. 1914), *cert. denied*, 235 U.S. 706 (1915) (necessity of payment rule premised on creditor's ability to halt operations).

equity, to have been dedicated to current debts.⁷¹ Thus, payments for the benefit of mortgagees out of income that should have been devoted to reduction of current debt give rise to a right in current creditors to invade the corpus to the extent of the diversion. Taxes paid, however, even though they redound to the benefit of the mortgagees, do not constitute a diversion.⁷² In addition, diversions that occurred prior to the creation of the six-months creditor's debt claim confer no right to invade the corpus because the creditor at that time had no special equity in current earnings.⁷³

The Supreme Court's decision in *Gregg* established that when payments for the benefit of mortgagees are offset by "free funds"—capital funds derived from sources not connected with the operation of the railroad, such as investments or borrowings—no diversion has occurred.⁷⁴ Although this proposition has not been discussed in any recent case, it is based on sound logic as long as the free funds are regarded as reimbursement *pro tanto* to the fund subject to the six-months claims.

Despite the Supreme Court's holding in *Gregg* that there can be no invasion of the corpus in order to satisfy six-months claims unless there previously has been a diversion from current earnings to the benefit of mortgagees, a line of cases in the Fourth Circuit has developed a current creditor's right to invade the corpus regardless of diversions.⁷⁵ In *Southern Railway v. Flournoy*,⁷⁶ the court held that income diversion to mortgagees is not a prerequisite to corpus invasion "where there are found—as special circumstances—all elements constituting the pre-eminent equity."⁷⁷ The *Flournoy* court, however, apparently confused the six-months rule with the necessity of payment rule.⁷⁸ The necessity of payment rule, as set forth in *Gregg*, allows invasions of corpus without any prior diversions only in the extraordinary situation in which actual *payment* of the claim is essential to the continued operation of

71. *Fosdick v. Schall*, 99 U.S. at 253.

72. *Texas Co. v. International & G.N. Ry.*, 237 F. 921 (5th Cir. 1916).

73. *Fordyce v. Omaha, K.C. & E.R.R.*, 145 F. 544 (W.D. Mo. 1906).

74. *See Gregg v. Metropolitan Trust Co.*, 197 U.S. 183 (1905), *aff'g* 124 F. 721 (6th Cir. 1903).

75. *See, e.g., Southern Ry. v. Flournoy*, 301 F.2d 847 (4th Cir. 1962); *Virginia Passenger & Power Co. v. Lane Bros.*, 174 F. 513 (4th Cir. 1909), *cert. denied*, 215 U.S. 610 (1910); *Finance Co. v. Charleston, C. & C.R.R.*, 62 F. 205 (4th Cir. 1894).

76. 301 F.2d 847 (4th Cir. 1962).

77. *Id.* at 851.

78. *See In re New York, N.H. & H.R.R.*, 278 F. Supp. at 602-03 n.15.

the road.⁷⁹ The special circumstances alluded to in the *Flournoy* decision⁸⁰ did not meet this standard. Thus the case, and the attendant Fourth Circuit line of decisions, must be regarded as wrongly decided.

It is unclear how depreciation should be regarded for purposes of the six-months rule. A diversion, as noted above, may be defined as any payment that enhances the interests of the mortgagees. Conversely, depreciation represents the decreasing value of the mortgage corpus over time. The question arises, then, whether depreciation should properly be regarded as an offset to diversionary amounts spent on additions and improvements by the debtor railroad. In the *New Haven* case, the district court held that operating creditors have no equitable claim on revenues to the extent of depreciation, asserting that such creditors have no equitable right to be protected from the economic fact of depreciation.⁸¹ In an earlier case, *Flint v. Danbury & Bethel Street Railway*,⁸² however, the Connecticut Supreme Court rejected an attempt by mortgagees to offset diversions for interest payments with depreciation expenses. In effect, the court held this would dedicate current earnings to the mortgagees to the extent of depreciation, contrary to the equitable principles of the rule.⁸³

In this context it is important to note that it is the addition or betterment that constitutes the enhancement of mortgaged property and, hence, the diversion. Depreciation would have occurred irrespective of whether any improvements were made to the mortgaged property. The two items, improvements and depreciation, are therefore not related and should not be combined as offsets. As discussed above,⁸⁴ depreciation is a paper transaction that does not affect the debtor railroad's short-term ability to pay current debts and thus should not serve to reduce the fund available for the payment of six-months claims.

79. See note 30 *supra*.

80. The "pre-eminent equity" asserted by the *Flournoy* court consisted of a combination of the six-months and necessity of payment rules. See 301 F.2d at 850-51. The claims for traffic balances that were granted priority in *Flournoy*, *id.* at 853-56, however, did not meet the stringent requirements of the necessity of payment rule.

81. 278 F. Supp. 592, 604 (D. Conn. 1967), *aff'd*, 405 F.2d 50 (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969).

82. 101 Conn. 13, 125 A. 194 (1924).

83. *Id.* at 20-21, 125 A. at 197.

84. See text accompanying notes 67 & 68 *supra*.

CONCLUSION

The utility of the six-months rule has suffered from a failure by many courts to properly analyze the basis of the rule. The rule is designed to protect the public's interest in the continued operation of the nation's railroads by assuring payment of operations creditors despite the precarious credit position of many railroads. The courts should not render illusory the protection offered by the rule by the application of inappropriate accounting standards; nor should the rule's purpose be compromised by the improper exclusion of the cost of necessary new purchases, or the inappropriate inclusion of charges for such items as depreciation. The six-months rule has not lost its relevance in the one hundred years since its inception—it has merely been misapplied.

ALAN E. KRAUS

Copyright Law—One Step Beyond Fair Use: A Direct Public Interest Qualification Premised On The First Amendment

In keeping with the copyright clause of the United States Constitution,¹ the purpose of the copyright statute² is to enhance the public welfare by promoting the growth of learning and culture.³ To accomplish this purpose, Congress has accorded the copyright holder certain

This Note has been entered in the Nathan Burkan Memorial Competition.

1. U.S. CONST. art. I, § 8, cl. 8: "The Congress shall have Power . . . To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries."

2. Copyrights Act, Pub. L. No. 94-553, 90 Stat. 2541 (1976) (codified at 17 U.S.C.A. §§ 101-810 (West 1977)). The Copyrights Act of 1976 revised Title 17 of the United States Code (governing copyrights) in its entirety. The new provisions became effective January 1, 1978, except §§ 118, 304(b) and 801, which became effective October 19, 1976. The substantive issues discussed in this Note concerning provisions of the former copyright statute are equally relevant to the new provisions.

3. See H.R. REP. NO. 2222, 60th Cong., 2d Sess. 9 (1909) (copyright act intended "not primarily for the benefit of the author, but primarily for the benefit of the public"). See also *Berlin v. E.C. Publications, Inc.*, 329 F.2d 541, 543-44 (2d Cir.), *cert. denied*, 379 U.S. 822 (1964); HOUSE COMM. ON THE JUDICIARY, 87TH CONG., 1ST SESS., COPYRIGHT LAW REVISION—REPORT OF THE REGISTER OF COPYRIGHTS ON THE GENERAL REVISION OF THE U.S. COPYRIGHT LAW 5 (Comm. Print 1961); Cohen, *Fair Use in the Law of Copyright*, 6 ASCAP COPYRIGHT L. SYMP. 43, 49 (1955).

quasi-exclusive rights in his copyrighted work,⁴ providing thereby an economic incentive for both the creation and the distribution of intellectual and cultural works.⁵ These rights are not absolute;⁶ traditional copyright qualifications such as the doctrine of fair use⁷ prevent the copyright owner from exercising total control over his work. There remain a few situations, however, in which the traditional qualifications do not prevent the economic interests of the copyright owner from overshadowing the public's interest in the widest possible dissemination of information and commentary.⁸ When the material is of such a nature that it cannot be reduced to an assortment of facts or ideas,⁹ it is clear that the copyright owner may prohibit any use of his copyrighted work that might reasonably be expected to diminish its potential marketability—even though the proposed use may be of benefit to the public welfare.¹⁰ For this reason, both courts and commentators have begun to suggest that the copyright monopoly be further narrowed by adoption of a direct public interest factor,¹¹ founded either on the constitutional purpose of the copyright statute¹² or on the first amendment

4. 17 U.S.C.A. §§ 101-118 (West 1977).

5. See *Mazer v. Stein*, 347 U.S. 201, 219 (1954).

6. The monopoly given the copyright owner is limited in duration. 17 U.S.C.A. § 302 (West 1977) (life of the author plus 50 years). The copyright statute is not intended to prohibit copying that is neither substantial nor material. A. LATMAN, FAIR USE OF COPYRIGHTED WORKS, STUDY NO. 14 (1958), prepared for and reprinted in SUBCOMM. ON PATENTS, TRADEMARKS, AND COPYRIGHTS, SENATE COMM. ON THE JUDICIARY, 86TH CONG., 2D SESS. (Comm. Print 1960) reprinted in 2 STUD. COPYRIGHT 781, 784 (1963). The copyright does not extend to facts or ideas contained in the copyrighted work. *Id.*; Sobel, *Copyright and the First Amendment: A Gathering Storm?*, 19 ASCAP COPYRIGHT L. SYMP. 43, 50 (1971).

7. The fair use doctrine allows for the reasonable and fair use of copyrighted material. See 2 M. NIMMER, NIMMER ON COPYRIGHT § 145 (1976 & Supp. 1976); Cohen, *supra* note 3. "Fair use may be defined as a privilege in others than the owner of the copyright, to use the copyrighted material in a reasonable manner without his consent, notwithstanding the monopoly granted to the owner by the copyright." A. LATMAN, *supra* note 6, at 783 (quoting BALL, THE LAW OF COPYRIGHT AND LITERARY PROPERTY 260 (1944)). The fair use doctrine was codified by the new Copyrights Act at 17 U.S.C.A. § 107 (West 1977). Copyrights Act, Pub. L. No. 94-553, § 107, 90 Stat. 2541 (1976).

8. See text accompanying notes 64-68 *infra*.

9. See notes 65 & 66 and accompanying text *infra*.

10. See, e.g., *Folsom v. Marsh*, 9 F. Cas. 342, 348 (C.C.D. Mass. 1841); *Marvin Worth Prods. v. Superior Films Corp.*, 319 F. Supp. 1269, 1274 (S.D.N.Y. 1970); *Hill v. Whalen & Martell, Inc.*, 220 F. 359 (S.D.N.Y. 1914).

11. See generally *Wainwright Sec. Inc. v. Wall St. Transcript Corp.*, 558 F.2d 91, 95-96 (2d Cir. 1977), *cert. denied*, 98 S. Ct. 730 (1978); *Morrissey v. Procter & Gamble Co.*, 379 F.2d 675, 678-79 (1st Cir. 1967); *Rosemont Enterprises, Inc. v. Random House, Inc.*, 366 F.2d 303, 307 (2d Cir. 1966), *cert. denied*, 385 U.S. 1009 (1967); *Berlin v. E.C. Publications, Inc.*, 329 F.2d 541, 544 (2d Cir.), *cert. denied*, 379 U.S. 822 (1964); *Time, Inc. v. Bernard Geis Assocs.*, 293 F. Supp. 130, 146 (S.D.N.Y. 1968); 1 M. NIMMER, *supra* note 7, § 9.2; Goldstein, *Copyright and the First Amendment*, 70 COLUM. L. REV. 983, 991 (1970); Rosenfield, *The Constitutional Dimension of "Fair Use" in the Copyright Law*, 50 NOTRE DAME LAW. 790, 807 (1975).

12. See text accompanying notes 44-50 *infra*.

right of the public to be fully informed.¹³ In the copyright infringement case of *Meeropol v. Nizer*,¹⁴ however, the United States Court of Appeals for the Second Circuit, when presented with the opportunity, refused to recognize or apply this direct public interest qualification. Instead, the court relied upon traditional copyright law concepts and found plaintiffs' economic interest in the copyright superior to defendants' claim of fair use.¹⁵ The court's holding represents a distinct departure from the trend toward recognition of a direct public interest qualification that had begun to emerge in the Second Circuit.¹⁶

The *Meeropol* case concerned *The Implosion Conspiracy*,¹⁷ a book about the Ethel and Julius Rosenberg espionage trial, in which the author, Louis Nizer, quoted from twenty-eight letters that had been published previously in a copyrighted book.¹⁸ The present owners of the copyright to this book of letters (the Rosenbergs' children, Robert and Michael Meeropol) brought suit in federal district court against Nizer and his publishers alleging that Nizer had infringed their statutory copyright.¹⁹ In response, Nizer and his codefendants asserted that their use of the quotations was both fair and reasonable and, therefore, permissible under the fair use doctrine, and on this ground moved for summary judgment.²⁰ After comparing the two books in question, the district court concluded that defendants had successfully established the defense of fair use²¹ and granted their motion for summary judgment.²²

13. See text accompanying notes 51-53 *infra*.

14. 560 F.2d 1061 (2d Cir. 1977), *cert. denied*, 98 S. Ct. 727 (1978).

15. *Id.* at 1070.

16. Though the Second Circuit had not adopted an express public interest qualification, the court had begun to give more consideration to the public interest and had revealed some inclination to consider the first amendment's relation to the copyright laws. See, e.g., *Wainwright Sec., Inc. v. Wall St. Transcript Corp.*, 558 F.2d 91 (2d Cir. 1977), *cert. denied*, 98 S. Ct. 730 (1978).

17. L. NIZER, *THE IMPLOSION CONSPIRACY* (1973).

18. *THE DEATH HOUSE LETTERS OF ETHEL AND JULIUS ROSENBERG* (1953).

19. 560 F.2d at 1063. The original complaint also alleged invasion of privacy and defamation and infringement of common law copyright. The Second Circuit, however, affirmed the dismissal of these claims. *Id.*

20. *Id.* at 1064. Defendants' original motion for summary judgment was denied without prejudice. 361 F. Supp. 1063, 1070 (S.D.N.Y. 1973). Defendants subsequently renewed their motion for summary judgment on the basis of an expanded record. 417 F. Supp. 1201, 1205 (S.D.N.Y. 1976).

As additional defenses, defendants asserted that a significant part of the allegedly appropriated material was already in the public domain, that plaintiffs were not the true copyright owners, and that plaintiffs should be barred by laches from bringing the action. 361 F. Supp. at 1065.

21. 417 F. Supp. 1201, 1214-15 (S.D.N.Y. 1976).

22. *Id.* at 1215. Plaintiffs waived their right to trial by jury against defendants Nizer and Doubleday & Co., Inc. but not as to defendant Fawcett Publications, Inc., *id.* at 1211, leading the trial court to find that the fair use defense was available to Nizer and Doubleday & Co., Inc., both as a matter of law and as a matter of fact.

In analyzing the fair use issue, the court gave primary consideration to the fact that the public interest in understanding all facets of the Rosenberg case would be served by publication of Nizer's book.²³ The potentially adverse effect of the use on the future marketability of the copyrighted letters was not considered sufficient to preclude defendants from invoking fair use as a defense.²⁴

The Court of Appeals for the Second Circuit, however, disagreed with the trial court's resolution of this apparent conflict between the respective interests of the public and the copyright owners. Rejecting the trial court's finding that the public's interest in the historical event was sufficient to establish the fair use defense regardless of the apparent economic harm to the copyright owners,²⁵ the court reversed the grant of summary judgment in defendants' favor and remanded the case.²⁶

The court of appeals' decision is consistent with the traditional application of the fair use doctrine. Though originally developed as a means of qualifying the exclusive rights of the copyright holder and protecting the interest of the public in the dissemination of learning and culture,²⁷ the doctrine of fair use was never intended to benefit the public welfare at the expense of the copyright owner's economic interests.²⁸ In determining whether the use made of copyrighted material in a particular case is a fair use, the courts generally have considered a number of factors;²⁹ it is evident from the case law, however, that the ultimate consideration is whether the unauthorized use tends to diminish or prejudice the potential marketability of the copyrighted

23. *Id.* at 1207.

24. *Id.* at 1210.

25. 560 F.2d at 1070.

26. *Id.* at 1071.

27. Cohen, *supra* note 3, at 49.

28. See generally cases cited note 10 *supra*.

29. The factors listed by the Second Circuit in *Meeropol* are the same as those found in the recent codification of the fair use doctrine at 17 U.S.C.A. § 107 (1977):

(1) the purpose and character of the use, including whether such use is of a commercial nature or is for nonprofit educational purposes;

(2) the nature of the copyrighted work;

(3) the amount and substantiality of the portion used in relation to the copyrighted work as a whole; and

(4) the effect of the use upon the potential market for or value of the copyrighted work.

560 F.2d at 1069.

Commentators on the fair use doctrine have suggested various sets of criteria that are essentially variations of the four factors listed above. See B. KAPLAN & R. BROWN, *CASES ON COPYRIGHT* 309-10 (2d ed. 1960); Cohen, *supra* note 3, at 53; Yankwich, *What is Fair Use?*, 22 U. CHI. L. REV. 203, 213 (1954). These lists have not been particularly helpful, however, because the criteria are defined only in general terms without specification of their relative weights. See Comment, *Copyright Fair Use—Case Law and Legislation*, 1969 DUKE L.J. 73, 87.

material.³⁰ Consideration of the purpose and character of the use has sometimes served to broaden the application of the fair use exception in the case of so-called "scholarly" works.³¹ It has been acknowledged that the public's interest in the advancement of such fields as science, law, medicine, history and biography often can be served only through the use of previously copyrighted materials.³² This public interest factor, however, has not been found sufficient to support alone the defense of fair use when the subsequent scholarly work might decrease the potential value of the copyrighted work:³³ a use having such an effect cannot be "fair" to the copyright owner because it undermines the economic incentive to discovery and creation that is the very basis of the quasi-monopolistic copyright system.³⁴

Until the *Meeropol* case, however, the Court of Appeals for the Second Circuit had appeared to favor recognition of a direct public interest factor as a possible defense in a copyright infringement action.³⁵ In *Rosemont Enterprises, Inc. v. Random House, Inc.*,³⁶ the court gave scant consideration to the possibility that the future market for copyrighted magazine articles about Howard Hughes might be diminished by the unauthorized use of the articles in a subsequent biography.³⁷ Instead, the court turned its attention to the nature of the materials, focusing on the issues of whether the copying work would serve the public interest in the free dissemination of information and whether its preparation required some use of previously copyrighted materials.³⁸ Though the *Rosemont* court couched its opinion in terms

30. See 2 M. NIMMER, *supra* note 7, § 145, at 646; A. LATMAN, *supra* note 6, at 783; Sobel, *supra* note 6, at 53.

31. See *Loew's, Inc. v. Columbia Broadcasting Sys., Inc.*, 131 F. Supp. 165 (S.D. Cal. 1955), *aff'd sub nom. Benny v. Loew's, Inc.*, 239 F.2d 532 (9th Cir. 1956), *aff'd by an equally divided Court*, 356 U.S. 43 (1958); A. LATMAN, *supra* note 66, at 793.

32. See *Rosemont Enterprises, Inc. v. Random House, Inc.*, 366 F.2d 303, 307 (2d Cir. 1966), *cert. denied*, 385 U.S. 1009 (1967).

33. See, e.g., *Folsom v. Marsh*, 9 F. Cas. 342, 348 (C.C.D. Mass. 1841).

34. See note 78 *infra*.

35. See *Wainwright Sec., Inc. v. Wall St. Transcript Corp.*, 558 F.2d 91 (2d Cir. 1977), *cert. denied*, 98 S. Ct. 730 (1978); *Berlin v. E.C. Publications, Inc.*, 329 F.2d 541 (2d Cir.), *cert. denied*, 379 U.S. 822 (1964).

36. 366 F.2d 303 (2d Cir. 1966), *cert. denied*, 385 U.S. 1009 (1967).

37. *Id.* at 310-11. The *Rosemont* court did not disregard the economic harm criterion entirely. Rather, the court maintained that the publication of the biography had not lessened the value of the copyrighted magazine articles. This position has been criticized for failing to take into account the possibility that the copyright owners could have used the articles in publishing a subsequent biography of their own. See 2 M. NIMMER, *supra* note 7, § 145 at 646-47; Sobel, *supra* note 6, at 57.

38. 366 F.2d at 307.

of fair use,³⁹ commentators were quick to see that the decision represented an aberrational extension of the fair use doctrine.⁴⁰ It is evident that defendants' copying of the magazine articles about Hughes did not constitute fair use⁴¹ within the traditional definition of that troublesome term.⁴² The decision is best understood as the adoption of a direct public interest factor.⁴³

The origin of this direct public interest qualification is not certain. The court in *Rosemont* relied heavily on the constitutional purpose of the copyright statute,⁴⁴ but because public interest traditionally has not been recognized as one of the express criteria for determining the availability of the fair use defense,⁴⁵ it seems doubtful that this innovation can be said to stem from the copyright clause of the Constitution.⁴⁶ In addition to setting forth the purpose for copyright, the copyright clause specifically empowers Congress to grant "to Authors . . . the exclusive Right to their respective writings."⁴⁷ In light of the legislative history of the Copyrights Act⁴⁸ and the fact that the fair use doctrine has been codified,⁴⁹ it must be presumed that the traditional judicial interpretation and application of the fair-use doctrine represents what Congress believes to be the proper balance between the constitutional purpose of promoting the arts and sciences and the broad power conferred by the Constitution for serving that purpose.⁵⁰

Another possible source of the direct public interest qualification, one that is not within the power of Congress to affect, is the first amendment.⁵¹ To the extent that the public's right to be fully informed

39. *Id.* at 306-11.

40. See 1 M. NIMMER, *supra* note 7, § 9.24, at 28.28; Sobel, *supra* note 6, at 54.

41. See note 7 *supra*. There can be little doubt that the unauthorized use of the Hughes material had a detrimental effect on its future economic value.

42. In *Dellar v. Samuel Goldwyn, Inc.*, 104 F.2d 661, 662 (2d Cir. 1939), the court stated that "the issue of fair use . . . is the most troublesome in the whole law of copyright."

43. See Sobel, *supra* note 6, at 61.

44. See 366 F.2d at 307.

45. See note 29 *supra*.

46. See U.S. CONST. art. I, § 8, cl. 8, *quoted in* note 1 *supra*.

47. *Id.*

48. See, e.g., S. REP. NO. 22, 94th Cong., 2d Sess. (1976); S. REP. NO. 1361, 93d Cong., 2d Sess. (1974); S. REP. NO. 644, 92d Cong., 1st Sess. (1971); H.R. REP. NO. 2512, 90th Cong., 1st Sess. (1967).

49. Copyrights Act, Pub. L. No. 94-553, § 107, 90 Stat. 2541 (1976) (codified at 17 U.S.C.A. § 107 (West 1977)).

50. See H.R. REP. NO. 1476, 94th Cong., 2d Sess. 65 (1976), *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 5659. See *Wainwright Sec., Inc. v. Wall St. Transcript Corp.*, 558 F.2d 91, 95 (2d Cir. 1977), *cert. denied*, 98 S. Ct. 730 (1978).

51. U.S. CONST. amend. I, § 2 provides in pertinent part that "Congress shall make no law . . . abridging the freedom of speech or of the press."

regarding matters of general import is threatened by the literal application of the copyright laws, the first amendment may be invoked to protect the free dissemination of information and commentary on public issues.⁵² Such an extrapolation of the first amendment would be consistent with the Supreme Court's interpretation and effectuation of the first amendment guarantees of freedom of speech and press.⁵³

The Supreme Court has revealed an intent to construe strictly any law that might have a chilling effect on the first amendment "in its attempt to secure the widest possible dissemination of information from diverse and antagonistic sources."⁵⁴ Likewise, the Court has indicated, by implication, that in order for the express guarantees of free speech and press to have any real meaning, a fundamental right to receive such information must be recognized.⁵⁵ These principles reveal the clear intent of the Supreme Court to remove any unnecessary shackles from the first amendment.⁵⁶ Applying these principles to the copyright laws, the primary issue becomes one of determining to what

52. See *Rosemont Enterprises, Inc. v. Random House, Inc.*, 366 F.2d at 311 (Lombard, C.J., concurring). But cf. *McGraw-Hill, Inc. v. Worth Publishers, Inc.*, 335 F. Supp. 415, 422 (S.D.N.Y. 1971) (court dismissed defendants' first amendment argument, insofar as it was distinguishable from traditional fair use defense, as "flying in the face of established law").

53. See, e.g., *Time, Inc. v. Hill*, 385 U.S. 374 (1967); *Lamont v. Postmaster Gen.*, 381 U.S. 301 (1965); *New York Times Co. v. Sullivan*, 376 U.S. 254 (1964).

54. *New York Times Co. v. Sullivan*, 376 U.S. 254, 266 (1964) (quoting *Associated Press v. United States*, 326 U.S. 1, 20 (1945)).

55. *Lamont v. Postmaster Gen.*, 381 U.S. 301, 307 (1965). The Court's holding, only implicit in the majority opinion, was expressly formulated by Mr. Justice Brennan in his concurring opinion. *Id.* at 308 (Brennan, J., concurring).

56. In *New York Times Co. v. Sullivan*, 376 U.S. 254 (1964), defendants were sued for libel after publishing a political advertisement that allegedly contained inaccurate information concerning plaintiff. The Court reversed the judgment in plaintiff's favor because there had been no showing that prior to publication defendants knew or recklessly disregarded the fact that the information was false. The Court held that without proof of scienter such a judgment would have a chilling effect on first amendment rights. *Id.* at 266.

In *Time, Inc. v. Hill*, 385 U.S. 374 (1967), defendants were sued for violating plaintiff's statutory right of privacy by reporting that a highly fictionalized play accurately portrayed an actual experience in plaintiff's life. Again, however, the Court reversed the judgment in plaintiff's favor, holding that "the constitutional protections for speech and press preclude the application of the [statutory right of privacy] to redress false reports of matters of public interest in the absence of proof that the defendant published the report with knowledge of its falsity or in reckless disregard of the truth." *Id.* at 387-88.

In *Lamont v. Postmaster Gen.*, 381 U.S. 301 (1965), the Court declared unconstitutional § 305(a) of the Postal Service and Federal Employees Salary Act of 1962, Pub. L. No. 87-793, § 305(a), 76 Stat. 833, that required addressees of "Communist political propaganda" to submit a written request for delivery. The Court held that the statute was "an unconstitutional abridgment of the addressee's First Amendment rights." 381 U.S. at 307 (emphasis added). In his concurring opinion, Mr. Justice Brennan emphasized that the addressees were asserting "First Amendment claims in their own right," claims premised on the implicit fundamental right to receive publications, a right that is necessary to make the express guarantees of free speech and press meaningful. *Id.* at 308 (Brennan, J., concurring).

extent the rights of the copyright owner will be allowed to encroach upon the "community right to hear."⁵⁷

It is quite unlikely that the first amendment was intended to negative completely the protection afforded all copyrighted material that happens to be of interest to the public.⁵⁸ Indeed, a broad application of the first amendment guarantee of freedom of speech in the public interest area would undermine the very foundation of the Copyrights Act, for copyrighted works typically are of interest to the public in one way or another. To allow unrestricted infringement of these works would result in the destruction of the economic incentive to create, publish and distribute copyrightable materials that might in any way be of benefit to the public welfare, and the "community right to hear" eventually would become a right without meaning.⁵⁹

Such a crippling application of the first amendment to the copyright laws is, however, unnecessary. The historical qualifications of a copyright owner's exclusive rights more often than not have been utilized successfully to achieve a proper balance between the public's interest in the growth of learning and culture and the copyright owner's interest in preserving the economic value of his work.⁶⁰ Because the facts and ideas set forth in a copyrighted work are not in themselves copyrightable,⁶¹ and because the copyrighted work itself may be used in a fair and reasonable manner,⁶² the public's interests can usually be served without depriving the copyright owner of his just remuneration.⁶³

There are certain types of copyrighted materials, however, that cannot be reduced to an assortment of facts or ideas because it is the form of expression and not merely the substance that is meaningful.⁶⁴

57. See Goldstein, *supra* note 11, at 989 (citing A. MEIKLEJOHN, *POLITICAL FREEDOM* 26-28 (1965)) (the first amendment intended to define "a community right to hear" and not "an individual right to speak").

58. Cf. *Curtis Publishing Co. v. Butts*, 388 U.S. 130, 150 (1967) ("the right to communicate information of public interest is not 'unconditional'").

59. See Sobel, *supra* note 6, at 78-79 (public interest best served ultimately by sound system of copyright protection).

60. For a general review of the fair use case law, see 2 M. NIMMER, *supra* note 7, § 145, and Cohen, *supra* note 3.

61. See A. LATMAN, *supra* note 6; Sobel, *supra* note 6.

62. See M. NIMMER, *supra* note 7.

63. See *Mazer v. Stein*, 347 U.S. 201, 219 (1954); HOUSE COMM. ON THE JUDICIARY, 87TH CONG., 1ST SESS., *supra* note 3, at 5-6.

64. In other words, the copyrighted material cannot be used in a distilled form and maintain its value; the part which is to be appropriated must be copied verbatim. The fair use doctrine allows for this type of use provided certain criteria are satisfied. See note 29 *supra*. If the fair use criteria cannot be satisfied, however, the copyright owner's monopoly becomes absolute.

As examples, Professor Nimmer lists such graphic works as the Mona Lisa, Michelangelo's Moses and the Zapruder film of President Kennedy's assassination;⁶⁵ arguably this category should include certain literary works as well.⁶⁶ For works of this nature, there is potentially a direct conflict between the copyright owner's quasi-monopolistic rights and the public's right to the widest possible dissemination of information and commentary because under the traditional interpretation of the fair use doctrine the copyright owner has the right to prohibit any use of his copyrighted material that might diminish its future marketability.⁶⁷ When traditional copyright qualifications are inadequate to protect the public's interests, a direct public interest qualification, premised on the first amendment, should be invoked to prevent the suppression of information or commentary that might enhance the public welfare, but that cannot be made available to the public in an effective manner without the use of previously copyrighted material.⁶⁸

The first essential element of this direct public interest qualification is that there must be some legitimate purpose for using the copyrighted material.⁶⁹ Generally, this requirement should be easy to satisfy. Though it is possible that copyrighted material may be appropriated for an improper purpose, such as commercial exploitation, any use of the copyrighted material that is intended to contribute to the intrinsic value of the copying work should qualify as a legitimate purpose.

Obviously, if the subsequent researcher cannot accomplish his purpose in an effective manner without a proscribed use of the copyrighted material, the public will be denied the benefit of that researcher's work. The problem is not that the copyrighted material is not directly available to the public, but that the public may be denied the benefit to be gained by a particular use of the copyrighted material in a subsequent work.

65. 1 M. NIMMER, *supra* note 6, § 9.232 at 28.22-28.23. The unauthorized use of the Zapruder film was the subject of litigation in *Time, Inc. v. Bernard Geis Assocs.*, 293 F. Supp. 130 (S.D.N.Y. 1968).

66. Provided that verbatim copying is necessary to the accomplishment of a legitimate purpose, there is no logical reason for excluding literary works. This should not create problems in the areas of poetry, fiction or drama since the purpose for using such works can be strictly scrutinized. For instance, limited quotation from such works for the purpose of literary criticism and parody has been allowed under the traditional fair use doctrine. See Cohen, *supra* note 3. But wholesale appropriation probably would not be allowed even under the more liberal direct public interest qualification because such a use would serve the same purpose as the original, and thus the only motivation for such copying would be personal profit.

67. See text accompanying notes 30-34 *supra*.

68. See *Wainwright Sec., Inc. v. Wall St. Transcript Corp.*, 558 F.2d 91 (2d Cir. 1977), *cert. denied*, 98 S. Ct. 730 (1978); Goldstein, *supra* note 11, at 994.

69. Cf. *Henry Holt & Co. v. Liggett & Myers Tobacco Co.*, 23 F. Supp. 302 (E.D. Pa. 1938) (portion of scientific treatise appropriated for purely commercial purpose of promoting the sale of defendant's cigarettes held not legitimate purpose).

The trial court in *Meeropol v. Nizer*, for example, expressed no difficulty in finding that there was a legitimate purpose for using the Rosenbergs' letters.⁷⁰ The court indicated that the letters themselves were part of the historical record of this important event and that any serious discussion of the case would be incomplete without some reference to them.⁷¹ In addition, the trial court found that the letters clearly were used to describe the thoughts and feelings of the Rosenbergs in relation to their trial and sentence.⁷²

On the other hand, the court of appeals in *Meeropol* expressed considerable doubt regarding the legitimacy of defendants' purpose for using the letters.⁷³ Noting that the letters were prominently featured in promotional material for defendants' book,⁷⁴ the court found that the letters may have been used for purposes of commercial exploitation.⁷⁵ It seems, however, that the court was confusing commercial motivation with commercial exploitation.⁷⁶ As the court conceded, the mere fact that an unauthorized use of copyrighted material is commercially motivated is not a sufficient reason for disallowing an otherwise valid fair use defense.⁷⁷ The specific promotional activities are merely elements of the overall commercial motivation.⁷⁸ The use of the letters in promotional advertisements was not alone a proper basis for questioning either the legitimacy of using the letters in the book or the intrinsic value of the book itself.

The second essential element of the direct public interest qualification is that the copying work be of interest to the public.⁷⁹ This does not mean that the copying work must represent a significant scientific or cultural achievement; indeed, the trial court in *Meeropol* found that *The Implosion Conspiracy* could be of some benefit to the public welfare even though it was written for a popular audience and with a

70. 417 F. Supp. 1201, 1214 (S.D.N.Y. 1976).

71. *Id.* at 1212, 1214.

72. *Id.* at 1214.

73. 560 F.2d at 1069-71.

74. *Id.* at 1071.

75. *Id.*

76. *Id.* at 1069.

77. *Id.*

78. The copyright system is based on providing an economic incentive for the creation and publication of new works. The Second Circuit has expressly recognized this underlying premise. See *Rosemont Enterprises, Inc. v. Random House, Inc.*, 366 F.2d at 307; *Berlin v. E.C. Publications, Inc.*, 329 F.2d 541, 543 (2d Cir.), *cert. denied*, 379 U.S. 822 (1964).

79. This is related to the traditional requirements of the fair use doctrine, see note 29 *supra*, and it is of special importance to the direct public interest qualification. See text accompanying notes 44-59 *supra*.

commercial motivation.⁸⁰ So long as there is some public interest in the copying work, this requirement is satisfied.

The final and most critical element is necessity: only if the purpose for using the copyrighted material can be accomplished by no means other than exact appropriation can the unauthorized use come within the sanction of the direct public interest qualification. If other means exist, then the interests of the public can be adequately protected without invoking any additional qualification of the copyright owner's rights. The trial court in *Meeropol* found that the only effective means of using the letters to accomplish the intended purposes was to quote from them directly.⁸¹ In so finding, the court expressly dismissed the suggestion that the thoughts and feelings embodied in the letters could have been presented effectively without copying their expression verbatim.⁸² In other words, the court found that verbatim copying was necessary to protect adequately the public's interest in hearing what Mr. Nizer and his publishers had to say about the Rosenberg case.

The propriety of the trial court in *Meeropol* finding necessity on defendants' motion for summary judgment is, however, open to question. Though there is no reason to question the legitimacy or sincerity of defendants' purposes in using the letters,⁸³ it would seem that reasonable men might differ concerning whether verbatim copying of the letters was really necessary to the accomplishment of those purposes. The defendants first asserted necessity in the use of the letters as historical facts in themselves.⁸⁴ It must be conceded that quotation would be necessary if the letters were found to be an integral component of the historical event. But certainly it is not clear that the letters could properly be considered analogous to historical facts.⁸⁵ Because the letters of

80. 417 F. Supp. 1201, 1209 (S.D.N.Y. 1976). For example, the trial court found that Nizer's book could serve as valuable source material for future studies of the Rosenbergs' case.

81. *Id.* at 1214.

82. *Id.* at 1212. The trial court also found that the use of the letters was properly limited to the accomplishment of the purposes. *Id.* at 1214.

83. Defendants set out the following purposes for using the letters in their book:

(1) as historical facts in themselves for the reason that they were an integral part of an international campaign to secure clemency; (2) to give the reader an insight into those two public figures as individuals . . . whose writing achieved a lasting eloquence; and (3) to provide an emotional base to support Nizer's own view that capital punishment in that case was unwarranted.

Petition for Certiorari at 6, *Nizer v. Meeropol*, 98 S. Ct. 927 (1978) (copy on file in office of *North Carolina Law Review*).

84. See note 83 *supra*.

85. Judge Tyler, the trial judge originally assigned to this case, expressed doubt concerning whether "letters stand on the same footing as 'historical facts', which are the product of research and in turn form the basis for subsequent works." 361 F. Supp. 1063, 1070 (S.D.N.Y. 1973). This

public figures are copyrightable,⁸⁶ while historical facts are not,⁸⁷ it would seem that the two are not analogous. If they were, the letters could be used without restriction, and the copyright on them would be meaningless.

Defendants' second alleged purpose was to provide insight into the character of the Rosenbergs.⁸⁸ Direct quotation from the letters may indeed have been the most effective means of accomplishing that purpose, but whether it was the only effective means is not so certain. It is probably true that reference to certain of the Rosenbergs' letters would be a necessary element in any serious book on their trial;⁸⁹ whether such references would require verbatim copying, however, is a genuine issue of fact that should be decided by the trier of fact after careful comparison of the materials in question. Particularly with regard to literary works, only in the most unusual cases will the need for exact copying be so evident as to warrant summary judgment in favor of the defendant.

The same holds true for defendants' third purpose,⁹⁰ the establishment of an emotional basis for the author's view on capital punishment in the Rosenbergs' case. Though the quotations may have heightened the emotional impact of this theme, only a careful examination of the two works can reveal whether the same sentiments could not have been expressed effectively by paraphrasing the content of the letters.

Thus it appears that even if *Meeropol* had been decided in a jurisdiction in which the direct public interest qualification was recognized, because the necessity element raised a genuine issue of fact the court of appeals' decision to remand would have been appropriate. This is not to say that the use of the letters in this instance was not necessary. On the contrary, there is good reason to believe that verbatim copying was the only effective means of accomplishing at least one, if not all, of the author's purposes for using the letters. But not until this issue is finally resolved can the direct public interest qualification be invoked as a de-

was one reason Judge Tyler denied defendants' original motion for summary judgment. Judge Gagliardi, who succeeded Judge Tyler when he resigned from the bench, however, went so far as to indicate that the letters were at least analogous to historical facts. 417 F. Supp. 1201, 1211 (S.D.N.Y. 1976).

86. See, e.g., *Folsom v. Marsh*, 9 F. Cas. 342 (C.C.D. Mass. 1841); Note, *Personal Letters: In Need of a Law of Their Own*, 44 IOWA L. REV. 705 (1959).

87. 560 F.2d at 1070. See also A. LATMAN, *supra* note 6, at 784-85.

88. See note 83 *supra*.

89. Even Judge Tyler was willing to concede that some reference to the letters would be required. 361 F. Supp. 1063, 1068 (S.D.N.Y. 1973).

90. See note 83 *supra*.

fense. Unfortunately, in *Meeropol* the Court of Appeals for the Second Circuit, by restricting its analysis of the case to the strict criteria of the traditional fair use doctrine, showed no interest in recognizing the public interest qualification.⁹¹ Because the fair use doctrine was never intended to benefit the public welfare at the expense of the copyright owner's economic interests,⁹² the court could not so easily dismiss the possibility of economic harm to the copyright owner.⁹³ And, having found the possibility of such harm to exist, the court of appeals was compelled to reverse the district court's summary judgment award.

If on remand defendants' use of the letters can be proven to have diminished the future marketability of the copyrighted work, then the fair use defense will be of no avail to defendants even if it can also be proven that the copyrighted material could not be used in an effective manner without infringing the copyright.⁹⁴ If this is to be the case, the public's right to hear a critical part of Nizer's discussion of the Rosenberg trial will be subordinated to the Meeropols' economic interest in exerting total control over the copyrighted letters.⁹⁵ It is to avoid such a constitutionally anomalous result⁹⁶ that the courts need to recognize this direct public interest factor as a legitimate and necessary qualification of the copyright owner's exclusive rights.

Provided the material is of such a type that the public's interest therein cannot be adequately served without infringing the copyright,

91. See text accompanying notes 80 & 81 *supra*.

The court attempted to distinguish its earlier decision in *Rosemont* on the grounds that plaintiffs in that case had not come into court with clean hands and that the amount of copying in *Rosemont* was quantitatively less than that in *Meeropol*. 560 F.2d at 1069. It seems clear, however, that by unequivocally relying on the strict criteria of the fair use doctrine in *Meeropol*, the court was implicitly rejecting the underlying basis of the *Rosemont* decision.

92. See generally cases cited note 10 *supra*.

93. "A key issue in fair use cases is whether the defendant's work tends to diminish or prejudice the potential sale of plaintiff's work." 560 F.2d at 1070; see note 10 and text accompanying notes 32-40 *supra*.

The trial court did not disregard the economic harm factor entirely. It merely held that economic harm was not necessarily the determinative issue. 417 F. Supp. 1201, 1214-15 (S.D.N.Y. 1976).

Because of the court of appeals' decision in this case, it is doubtful that the issue of necessity in *Meeropol* will be litigated on remand. Limited by law of the case principles to the traditional copyright qualifications, defendants probably will not be allowed to litigate the issue of necessity directly, though it may come into play as a collateral issue in the fair use defense. Nor is it likely that the issue will be raised again on appeal, as the facts of the case are such that the traditional fair use defense should result in a judgment in defendants' favor. Because of the nature of defendants' use, it seems doubtful that plaintiffs will be able to prove a likelihood of economic harm.

94. See note 10 and accompanying text *supra*.

95. Though the public may have access to the Rosenbergs' letters, they will not have access to that part of Nizer's discussion of the case that depends on the use of the letters.

96. See text accompanying notes 51-57, 67 & 68 *supra*.

the benefit to be gained from allowing the free dissemination of information and commentary far outweighs the possible economic harm to the copyright owner. The public's right to be informed must be the ultimate concern. "We cannot recognize copyright as a game of chess in which the public can be checkmated."⁹⁷

STEVEN L. HOARD

Corporations—*Singer v. Magnavox Co.*: An Expansion of Fiduciary Duty in Freezeout Mergers Under the Delaware Long-Form Merger Statute

Under the law of some states a corporation holding a majority equity interest in another company may merge the two corporations and provide in the merger agreement that certain shareholders be paid cash, rather than securities in the resulting entity, for their interest in the old corporation.¹ In these mergers, denominated "freezeouts,"² the fiduciary duties governing the relationship between majority and minority stockholders are rooted in state law.³ In *Singer v. Magnavox Co.*,⁴ a recent decision concerning shareholder fiduciary duties, the Delaware

97. *Morrissey v. Procter & Gamble*, 379 F.2d 675, 679 (1st Cir. 1967).

1. See, e.g., DEL. CODE tit. 8, § 251 (1974 & Cum. Supp. 1977); N.Y. BUS. CORP. LAW §§ 901, 902 (McKinney 1963 & Supp. 1977).

2. Freezeouts can occur in various contexts. For example, merger freezeouts include the situation in which the controlling shareholders of a public corporation who wish to "go private" form a second company and capitalize it with their equity interest in the public corporation. This new "parent" then merges with its public subsidiary with the terms of the merger providing for the elimination of the equity interest of the minority, often on a cash-out basis. A second type of freezeout occurs when one corporation, by tender offer or otherwise, attempts to acquire the majority interest in a business with which it was previously unaffiliated. After the requisite proportional interest is obtained, the acquiring corporation merges the acquired company with itself or its wholly-owned subsidiary, the terms of the merger providing for the elimination of the minority shareholders of the target corporation. See Greene, *Corporate Freeze-Out Mergers: A Proposed Analysis*, 28 STAN. L. REV. 487, 491-96 (1976).

3. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977), in which the Supreme Court held that in short-form mergers the fiduciary relationship between stockholders is a matter of state concern. Specifically, *Santa Fe* rejected the contention that § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (1976), and rule 10b-5, 17 C.F.R. § 240.10b-5 (1977), require a proper business purpose to exist before a short-form merger comporting with state law will be valid under federal law. The Court suggested that the reasoning behind its holding is also applicable to long-form mergers. 430 U.S. at 478.

4. 380 A.2d 969 (Del. 1977).

Supreme Court held that it is a breach of fiduciary duty under state law for a controlling shareholder to cause such a merger through utilization of Delaware's long-form merger statute⁵ when the sole purpose of the merger is to cash out minority stockholders.⁶

The controversy in *Singer* began in 1974 when North American Philips Corporation (North American) incorporated a wholly-owned subsidiary, North American Philips Development Corporation (Development), for the purpose of making a tender offer for the outstanding common shares of Magnavox. After overcoming the initial resistance of the Magnavox directors,⁷ the offer succeeded with Development obtaining approximately 84.1% of outstanding Magnavox common stock. Development next incorporated a subsidiary, T.M.C. Development Corporation (T.M.C.), and proposed to effect a merger between T.M.C. and Magnavox under the long-form merger provision of the Delaware Code. The Magnavox board unanimously approved the proposed merger agreement,⁸ which provided that the remaining public stockholders of Magnavox would be "cashed-out."⁹

5. DEL. CODE tit. 8, § 251 (1974 & Supp. 1977). This section is the primary merger provision of the Delaware Code. It provides that two or more Delaware corporations may merge into a single corporation or consolidate into a new entity. The provision requires that the board of directors of each corporation approve an agreement that stipulates the merger terms and that this agreement subsequently be approved by shareholders holding a majority of outstanding shares entitled to vote on the matter. To be included in the merger agreement are provisions regarding the manner in which shares of the constituent corporation will be converted or eliminated.

Section 251(b)(4) provides that the merger agreement will state:

[T]he manner of converting the shares of each of the constituent corporations into shares or other securities of the corporation surviving or resulting from the merger or consolidation and, if any shares . . . are not to be converted . . . the cash, property, rights or securities of any other corporation which the holders of such shares are to receive . . .

Id. § 251(b)(4) (Cum. Supp. 1977).

The long-form statute is currently more permissive than as originally written with respect to the types of consideration that can be paid for a stockholder's interest in a premerger corporation. For a brief history of the development of Delaware's long-form statute, see Balotti, *The Elimination of the Minority Interests by Mergers Pursuant to Section 251 of the General Corporation Law of Delaware*, 1 DEL. J. CORP. L. 63 (1976).

6. 380 A.2d at 980. The supreme court also interpreted the Delaware Securities Act, DEL. CODE tit. 6, § 7303 (1974), to be a state Blue Sky law applicable only to transactions subject to Delaware jurisdiction. It held that out-of-state transactions are not covered by the Act even if the company involved were incorporated in Delaware. 380 A.2d at 981-82.

7. The opposition was suspended after agreement had been reached to increase the original per-share offer and to contract with 16 Magnavox officers for two-year employment contracts. See 380 A.2d at 971.

8. *Id.* at 972. At this time Development effectively controlled the Magnavox board: four of the nine directors were also directors of North American and three others had employment contracts.

9. The cash-out price was \$9.00 per share and book value was estimated at \$10.16 per share. This discrepancy was one ground on which the merger was attacked. See *id.* at 972. Cash freezeouts are discussed in note 2 *supra*.

After the required stockholders' vote, plaintiffs, minority shareholders in Magnavox, filed suit seeking nullification of the consolidation as well as compensatory damages. They alleged that the merger was fraudulent because it did not serve any business purpose other than the forced exclusion of public stockholders from an equity position in Magnavox, that the price offered was inadequate and therefore constituted a breach of duty by Development, the majority shareholder, and that the merger violated the antifraud provision of the Delaware Securities Act.¹⁰ The lower court determined that plaintiffs had failed to state a claim upon which relief could be granted.¹¹ The supreme court reversed, holding that a majority shareholder owes a fiduciary duty to a minority and that it is a breach of that duty when a long-form merger is effected for the sole purpose of eliminating a noncontrol interest.¹² Rather, before a minority may be eliminated in a long-form merger, a proper business purpose for the combination must exist.¹³

This holding is significant because of its emphasis on and redefinition of the fiduciary duty of controlling shareholders. Delaware's long-form merger statute does not explicitly require, and the state's courts generally have not implied, the necessity of a proper business purpose as a precondition of the validity of any merger.¹⁴ The requirement

10. 380 A.2d at 972.

11. See 367 A.2d 1349, 1358, 1362 (Del. Ch. 1976).

12. 380 A.2d at 980. The fiduciary duty was predicated, the court found, on the majority's responsibility toward plaintiffs' investment interest in Magnavox. Significantly, the court held that this interest extended not merely to the value of the investment but also to its form. Therefore, it found that offering a minority merely a fair price for its shares in a cash-out merger would not satisfy the fiduciary obligation, and that defendant's duty was not lessened by the availability to the minority of the right to elect an appraisal. For a discussion of statutory appraisal rights, see notes 19 & 20 and accompanying text *infra*.

13. See 380 A.2d at 978-79. The court did not find it necessary to determine which corporation's business interest should be served in the merger. But in *Tanzer v. International Gen. Indus., Inc.*, 379 A.2d 1121 (Del. 1977), a case decided after *Singer* and involving a cash-out long-form merger, the Delaware Supreme Court held that one looked to the business rationale of the parent corporation. The court, however, objected to phrasing the standard in terms of business purpose since it is the parent corporation's status as a stockholder that gives it the right to vote its own interest. *Id.* at 1123. Although this distinction is useful for a conceptual understanding of the *Tanzer* decision, its practical importance in determining the legality of mergers seems problematical because some bona fide business purpose is a prerequisite to merger validity. See *id.* at 1124.

14. The *Singer* court cited two unreported Delaware cases that according to the court suggest that a business justification is required in long-form merger cases. 380 A.2d at 975 n.5 (discussing *Tanzer v. International Gen. Indus., Inc.*, No. 4945 (Del. Ch. Dec. 23, 1975); *Pennsylvania Mut. Fund, Inc. v. Todhunter Int'l, Inc.*, No. 4845 (Del. Ch. Aug. 5, 1975)).

One federal court also has discussed business purpose in the context of a long-form merger. In *Grimes v. Donaldson, Lufkin, & Jenrette, Inc.*, 392 F. Supp. 1393 (N.D. Fla. 1974), *aff'd*, 521 F.2d 812 (5th Cir. 1975), plaintiff sought to prevent a merger between two Delaware corporations on various grounds, including an allegation that the merger served no business function. Apply-

that there be a business purpose other than the elimination of a minority interest in long-form mergers runs counter to the general trend of Delaware statutory and case law which has, in general, encouraged consolidations by placing progressively fewer restraints on majority shareholders desiring to effect corporate mergers.¹⁵

The existence of merger provisions in the Delaware Code has been considered by courts to be evidence of a state policy in favor of facilitating mergers.¹⁶ Because the merger statutes are considered part of every corporate charter, stockholders purchase shares with notice of the provisions, a fact courts have cited in dismissing merger challenges.¹⁷ This interpretation of the policy of the statutes has meant that fewer limitations have been placed on controlling shareholders when making merger decisions than have been placed on them when making other decisions regarding corporate assets or functions.¹⁸

ing Delaware law, the court entered judgment for defendants, finding that there was a valid business purpose for the merger but also stressing that a minority did not possess an absolute right to its shares; therefore, it could be cashed out for a fair price. *Id.* at 1403.

While the *Grimes* court purported to apply Delaware law, it never made a specific finding that the state law required a business purpose. Rather, the court apparently considered the business purpose of the merger to be relevant on the basis of *Bryan v. Brock & Blevins Co.*, 490 F.2d 563 (5th Cir.), *cert. denied*, 419 U.S. 844 (1974), a case in which the Court of Appeals for the Fifth Circuit construed a Georgia statute similar to Delaware's long-form provision. The *Bryan* court concluded that under Georgia law a control group could not force a merger for the sole purpose of eliminating a minority shareholder. Unlike *Singer* and *Grimes*, *Bryan* did not involve the attempt of one corporation to take over another; rather, it involved the attempt of several shareholders of a close corporation to freeze out another shareholder. For an analysis of the *Grimes* court's application of the *Bryan* business purpose test, see Comment, *Corporate Freeze-Outs Effected by Merger: The Search for a Rule*, 37 U. PITT. L. REV. 115, 121-24 (1975).

On the other hand, some cases and commentators have asserted that business purpose is not a consideration under Delaware's merger law. See *MacCrone v. American Capital Corp.*, 51 F. Supp. 462, 466 (D. Del. 1943); *Bruce v. E.L. Bruce Co.*, 40 Del. Ch. 80, 174 A.2d 29, 30 (1961); *Arsht, Minority Stockholder Freezeouts Under Delaware Law*, 32 BUS. LAW. 1495, 1497 (1977); *Balotti, supra* note 5, at 77.

15. See notes 24-34 and accompanying text *infra*.

16. See, e.g., *Federal United Corp. v. Havender*, 24 Del. Ch. 318, 11 A.2d 331 (1940); *Bruce v. E.L. Bruce Co.*, 40 Del. Ch. 80, 174 A.2d 29 (1961).

17. See *Federal United Corp. v. Havender*, 24 Del. Ch. 318, 334, 11 A.2d 331, 338 (1940).

18. These nonmerger cases often involve majority shareholder action relating to the control of corporate assets and internal corporate functioning. An early decision held that while the decision to sell corporate assets is a shareholder determination, the terms of the sale must be fair to the corporation. See *Allied Chem. & Dye Corp. v. Steel & Tube Co. of Am.*, 14 Del. Ch. 1, 11, 120 A. 486, 490 (1923). A subsequent case hypothesized that even if the terms of sale are fair, a court of equity might enjoin a merger when a control group attempts to freeze out a minority by selling corporate assets to themselves. See *Allaun v. Consolidated Oil Co.*, 16 Del. Ch. 318, 323-24, 147 A. 257, 260 (1929).

More generally, Delaware courts have held that corporate mechanisms may not be used to perpetuate corporate control at another's expense. Thus, the court in *Condec Corp. v. Lunkenheimer Co.*, 43 Del. Ch. 353, 230 A.2d 769 (1967), cancelled an issuance of stock that was designed to frustrate plaintiff's successful tender bid for a majority of defendant's outstanding shares. See also *Petty v. Penntech Papers, Inc.*, 347 A.2d 140 (Del. Ch. 1975); *Yasik v. Wachtel*,

The liberal attitude displayed by courts toward mergers has been reinforced by the existence of appraisal rights for stockholders who dissent from a merger.¹⁹ To request an appraisal, a shareholder must vote against the proposal and file a petition in court. The court then determines the value of the dissenting stockholder's interest in the premerger corporation.²⁰ This appraisal right is significant because it has often been held to be an adequate remedy for a shareholder dissatisfied with a merger.²¹

The favorable predisposition toward corporate combinations, however, has been tempered by various limitations on a control group's right to force a merger in contravention of a minority's interest. Early cases held that a merger would be enjoined when a minority established that a control group had engaged in fraudulent practices. Before the long-form statute provided for cash payments for eliminated shares, a control faction could formulate unfavorable merger terms and virtually assure that dissatisfied stockholders would invoke their appraisal rights and be paid cash for their interests in the premerger company. Notwithstanding the appraisal remedy it was held that in the presence of such fraud a court of equity would enjoin the merger.²² Moreover, courts went beyond the requirement of actual fraud and recognized a claim for relief based upon a showing of "constructive fraud," a type of fraud that results from a reckless but nondeceptive undervaluation of a minority's interest.²³

25 Del. Ch. 247, 17 A.2d 309 (1941). In *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437 (Del. 1971), Chris-Craft's technical compliance with Delaware law in changing the annual shareholders' meeting date was held to be insufficient to prevent a preliminary injunction from issuing when the change was designed to inhibit plaintiff's efforts to solicit proxies for a rival slate of directors. *But see American Hardware Corp. v. Savage Arms Corp.*, 37 Del. 59, 136 A.2d 690 (1957). The above cases illustrate the principle that in nonmerger situations, notwithstanding compliance with technical statutory requirements, Delaware courts will carefully scrutinize majority shareholder action to ensure that the noncontrol group is dealt with fairly.

19. See DEL. CODE tit. 8, § 262 (1974 & Cum. Supp. 1977).

20. The statute provides that the determination of value should exclude any increment in value arising from the merger itself. *Id.* § 262(f) (Cum. Supp. 1977).

21. See note 28 *infra*.

22. See, e.g., *Cole v. National Cash Credit Ass'n*, 18 Del. Ch. 47, 156 A. 183 (1931).

23. See *id.* at 56-57, 156 A. at 187; *accord*, *Porges v. Vadsco Sales Corp.*, 27 Del. Ch. 127, 133, 32 A.2d 148, 151 (1943); *MacFarlane v. North Am. Cement Corp.*, 16 Del. Ch. 172, 157 A. 396 (1928). One court suggested that the discrepancy between actual and proffered value must shock the court's conscience in order to reach the level of constructive fraud. See *Bruce v. E.L. Bruce Co.*, 40 Del. Ch. 80, 82, 174 A.2d 29, 30 (1961). In cases in which constructive fraud is alleged in mergers involving previously unaffiliated corporations, it has been held that the burden of proof is on the dissenting shareholders to show manifestly unfair terms. See *Cole v. National Cash Credit Ass'n*, 18 Del. Ch. 47, 58, 156 A. 183, 188 (1931); *cf.* *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. 293, 298, 93 A.2d 107, 109-10 (Sup. Ct. 1952) (burden of proof shifted in interested mergers). For an illustration of some of the factors a court will consider in determining

In *Sterling v. Mayflower Hotel Corp.*,²⁴ the seminal case on fiduciary obligations of majority stockholders in interested mergers, the Delaware Supreme Court held that a corporation standing on both sides of a merger has the burden of proving the "entire fairness" of it.²⁵ The phrase "entire fairness" was not expressly defined by the *Sterling* court, but was employed as the standard to determine whether defendant corporation had used its position to undervalue the minority's interest. In equating fairness with value, however, there is no indication that the *Sterling* court intended fairness to include the necessity of a proper business purpose for the merger; indeed, other cases under Delaware law have held that business necessity is not a consideration under the state's merger statutes.²⁶

Subsequent cases involving interested long-form mergers have been inconsistent in applying the fiduciary obligation enunciated in *Sterling*. At times courts have not recognized the applicability of the obligation to prove fairness,²⁷ while other courts have diluted the impact of *Sterling* by implying that the existence of statutory appraisal mitigates a parent corporation's burden of establishing fairness.²⁸ This

relative share valuation in proposed mergers, see *Bastian v. Bournes, Inc.*, 256 A.2d 680, 683-84 (Del. Ch. 1969), *aff'd per curiam*, 278 A.2d 467 (Del. 1970).

24. 33 Del. Ch. 293, 93 A.2d 107 (Sup. Ct. 1952). *Sterling* involved a merger challenge in which minority shareholders attacked the proposed share exchange ratio offered by the parent corporation.

25. This fiduciary duty was derived from cases that had construed the duties of corporate directors and officers toward the corporation and its shareholders. The theme that runs throughout these cases is that officers and directors must deal fairly with the corporation and its shareholders. Any actions by which these persons attempt to usurp corporate opportunities, bring benefits solely to themselves, unfairly perpetuate their control over the corporation or favor one class of stockholders over another is a breach of fiduciary duty. See, e.g., *Kaplan v. Fenton*, 278 A.2d 834 (Del. 1971); *Dolese Bros. v. Brown*, 39 Del. Ch. 1, 157 A.2d 784 (Sup. Ct. 1960); *Guth v. Loft*, 23 Del. Ch. 255, 5 A.2d 503 (Sup. Ct. 1939).

26. See note 14 *supra*.

27. See *Bruce v. E.L. Bruce Co.*, 40 Del. Ch. 80, 174 A.2d 29 (1961). *Bruce* involved an interested merger in which a minority shareholder sought to enjoin the merger on the ground that the proposed exchange ratio for shares was constructively fraudulent. The court dismissed the complaint on the basis that the alleged value of plaintiff's interest was unrealistically high and therefore constructive fraud had not been proven. The court implied that under the circumstances recourse to appraisal was adequate. *Id.* at 82, 174 A.2d at 30. In *David J. Greene & Co. v. Dunhill Int'l, Inc.*, 249 A.2d 427 (Del. Ch. 1968), however, the court followed *Sterling*, holding that the minority shareholders' allegations of unfair valuation and usurpation of corporate opportunities by defendant parent corporation justified the issuance of a preliminary injunction. *Bruce* was distinguished on the ground that the plaintiff in that case had apparently not brought the applicability of *Sterling* to the court's attention. *Id.* at 431.

28. See *David J. Greene & Co. v. Schenley Indus., Inc.*, 281 A.2d 30 (Del. Ch. 1971). In *Schenley* the parent corporation conceded its obligation to establish fairness, but the court held that the burden had been met when the parent had established that the price offered was not fraudulent. *Id.* at 33. In so holding, the court reasoned that the parties were merely in a dispute over value, and, because the court construed the rights of a minority stockholder in a long-form

seeming reluctance to give full effect to the *Sterling* decision parallels the Delaware Supreme Court's own interpretation of mergers under the state's short-form merger statute.²⁹ This provision provides for an expedited merger procedure when one corporation owns at least a 90% interest in another company. Such mergers, involving one corporation on both sides of the transaction, are by definition "interested." Yet in *Stauffer v. Standard Brands, Inc.*³⁰ the supreme court, despite plaintiff's allegations of constructive fraud, held that in short-form mergers the statutory appraisal right is an adequate remedy when the only relief sought is the monetary value of an interest.³¹ In making the availability of appraisal dispositive of the minority's claim, the supreme court in *Stauffer* was impliedly rejecting *Sterling's* requirement that in an interested merger the majority must prove fairness. Furthermore, the court in *Stauffer* noted that it would be difficult to foresee a short-form merger that could be nullified for fraud.³² The *Stauffer* decision is particularly significant because of one court's holding that due to the presence in both the long- and short-form merger statutes of provisions allowing for cash payments of eliminated interests,³³ the rights of a minority shareholder in long-form mergers are no greater than those in short-form mergers.³⁴ Thus, prior to *Singer* it appeared that some Delaware courts were prepared to hold that because appraisal constitutes an adequate and complete remedy a long-form cash-out merger could not be enjoined for fraud.

In general, a review of statutory and case law reveals several elements of Delaware corporate law that have influenced courts in determining the legality of majority stockholder action in interested long-

merger to be no greater than those in short-form mergers, appraisal was an adequate remedy for the dissatisfied stockholders. *Id.* at 33, 35.

The *Sterling* court had not specifically addressed the interrelationship between the appraisal remedy and the fiduciary duty of a parent corporation. At a minimum, as the *Schenley* court found, *Sterling* requires the controlling corporation to prove the absence of fraud. A more interesting question is whether the *Sterling* court would have required the control shareholder in *Schenley* to go beyond negating the plaintiff's fraud allegations and make a positive showing of the fundamental fairness of the merger terms. The dismissal of the merger challenge by the *Schenley* court indicates that that court impliedly rejected such a stringent formulation of majority fiduciary duty.

29. DEL. CODE tit. 8, § 253 (1974 & Cum. Supp. 1977).

30. 41 Del. Ch. 7, 187 A.2d 78 (Sup. Ct. 1962).

31. *Id.* at 10-11, 187 A.2d at 80.

32. *Id.* But see *Braasch v. Goldschmidt*, 41 Del. Ch. 519, 199 A.2d 760 (1964) (motion to dismiss challenge to short-form merger denied when plaintiff alleged fraud by parent corporation).

33. See DEL. CODE tit. 8, §§ 251, 253 (1974 & Cum. Supp. 1977).

34. See *David J. Greene & Co. v. Schenley Indus., Inc.*, 281 A.2d 30, 35 (Del. Ch. 1971).

form mergers. Influencing merger approval is the view that merger statutes reflect a public policy favoring mergers and, therefore, that mergers should only be enjoined on the basis of supervening equities.³⁵ This predisposition has been reinforced by the tendency to view the appraisal right as an exclusive remedy³⁶ and by legislative acts that have both liberalized and reduced the distinctions between the long- and short-form merger provisions.³⁷ On the other hand, courts have shown a reluctance to sanction the manipulation of corporate machinery for the perpetuation of a control position.³⁸ Moreover, courts have generally recognized in all long-form mergers that majority shareholders owe a fiduciary duty to act fairly to minority stockholders and that the obligation is strongest when the controlling shareholder is a parent corporation.³⁹

In assessing the validity of a long-form merger, particularly one in which one party is interested, it is necessary to accommodate these conflicting decisional factors. Cases prior to *Singer* reveal that the conflict between the factors was resolved by rejecting the necessity of close scrutiny of interested mergers and adopting the view that a minority was dealt with fairly whenever it was paid the fair value of its interest.⁴⁰ Often, appraisal was cited as an appropriate mechanism to satisfy this latter goal. *Singer*, in contrast, held that a stockholder has an interest not only in the value of his shares but also in the form of his investment and that therefore appraisal is not an appropriate remedy in a cash-out merger under the long-form statute. The significance of this holding is twofold. First, while there is a recognition that a minority's interest is not inviolable, the Delaware Supreme Court found that it could only be abrogated for a valid business purpose and that the elimination of a minority solely to allow the majority unfettered control does not constitute such a purpose. Second, the decision may be interpreted as reaffirming *Sterling's* emphasis on the fiduciary obligations of majority stockholders, despite contrary trends in Delaware law. Thus, the court expanded the fiduciary obligations of controlling shareholders in cash-out mergers under the long-form statute through the imposition of a requirement of proper business purpose, while it simultaneously em-

35. See cases cited notes 16 & 17 *supra*.

36. See note 28 *supra*.

37. See Balotti, *supra* note 5.

38. See note 18 *supra*.

39. See notes 27 & 28 *supra*.

40. See notes 27-34 and accompanying text *supra*.

phasized that appraisal could not serve as a substitute for fiduciary duty.

In requiring that a business purpose exist in a long-form merger in which a minority is to be eliminated, the *Singer* court arguably did not lay an adequate basis for its decision through analysis of Delaware statutory law and prior decisions. The court relied heavily on a series of nonmerger cases that stand for the proposition that a control faction cannot perpetuate its position at the expense of a minority even when the noncontrol group is paid a fair value for its interest.⁴¹ On the basis of these decisions the *Singer* court held that it is a breach of fiduciary duty in a long-form merger for a majority shareholder to freeze out a minority without a business justification. The applicability of prior merger cases that had either expressed or implied that business purpose has no function in determining the validity of mergers under Delaware law was rejected on the ground that none of those cases involved a cash-out merger whose sole purpose was to eliminate a minority.⁴² In its rejection of the applicability of prior merger law, however, the court neglected to address the policy of liberality toward mergers that these decisions exemplified. This leniency, in fact, seems to have traditionally distinguished the application of fiduciary standards in merger cases from the application of such principles in other areas of corporate life.⁴³ The *Singer* court's reliance on nonmerger case law, therefore, tends to obscure the true significance of the opinion, because it conceals the degree to which the case both strengthens and expands the fiduciary obligations recognized by the *Sterling* court. Nevertheless, the importance of *Singer* to Delaware law will not go unrecognized because the inclusion of business purpose as a component of fiduciary duty in long-form corporate mergers is a significant departure from prior law.⁴⁴

41. See 380 A.2d at 976-77. See note 18 *supra* for a discussion of Delaware's treatment of shareholder fiduciary duties in nonmerger situations.

42. See 380 A.2d at 978.

43. See Balotti, *supra* note 5, at 74-77.

44. The court's opinion left some questions unanswered. The major unanswered question was whose business purpose should be determinative of legality; this problem was resolved in *Tanzer v. International Gen. Indus., Inc.*, 379 A.2d 1121 (Del. 1977), discussed in note 13 *supra*. Moreover, while some language in *Singer* might be construed as requiring a business purpose in short-form mergers, the question was not decided. See 380 A.2d at 979-80. Short-form mergers cannot automatically be presumed to involve the same fiduciary duties as long-form mergers. The differences in the provisions governing short- and long-form mergers might indicate a legislative judgment that the rights attaching to minority stock ownership are more clearly outweighed by corporate interests when a parent owns over 90% of its subsidiary than when a lesser interest is held. This possibility, however, leads to the anomaly that in some instances fiduciary duty is inversely related to degree of ownership.

Although *Singer v. Magnavox Co.* does not harmonize with prior Delaware merger law, it cannot be condemned as improperly decided. By injecting considerations of business purpose into determinations of merger validity, the supreme court simply recognized a factor not previously deemed important under state law. The propriety of this equitable decision should be assessed in terms of competing policies that favor both mergers and protection of the investment interests of minority shareholders who wish to retain their stock in a corporation. Accordingly, the *Singer* decision clearly does not frustrate the state's substantive policy of corporate flexibility that is revealed in the case law. A corporation may still effect a merger and eliminate a minority's equity interest with a cash or other payment, subject only to the qualifications of fairness and a proper business objective. And, while some might contend that a minority shareholder should only be entitled to the value of his interest,⁴⁵ it seems reasonable that an individual, having made an investment, should not be forced to sell out absent some superior interest.⁴⁶ The inadequacy of merely receiving share value is particularly apparent in light of the possibility of majority abuse in the valuation of a noncontrol interest and in deficiencies in statutory appraisal rights.⁴⁷ The requirement of a business purpose does not, of course, eliminate the problems in either majority valuation or statutory appraisal, but it does help assure that these mechanisms will not be utilized to frustrate the legitimate investment goals of minority stockholders.⁴⁸

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45. See Arsh, *supra* note 14. It might be reasonable to conclude that a majority shareholder's interest varies according to the type of merger involved. A distinction might be made between freezeouts of noncontrolling stockholders in close corporations versus those situations in which the freezeout is incident to an acquisition attempt. A business requirement might be more reasonable in the former type of merger. See Greene, *supra* note 2, at 499-502.

46. See Note, *Elimination of Minority Share Interest by Merger: A Dissent*, 54 NW. U.L. REV. 629 (1959).

47. Various flaws have been identified in construing a right of appraisal as a complete remedy. For example, factors necessary to fairly evaluate an interest may be concealed; the costs incurred in appraisal reduce its value as an option; and when the value of an interest is speculative, conservative results may be expected. See Vorenburg, *Exclusiveness of the Dissenting Stockholder's Appraisal Right*, 77 HARV. L. REV. 1189, 1201-05 (1964). Moreover, when the market value of an interest is likely to be determinative of an appraisal decision, the likelihood of a freezeout can depress share value. See Greene, *supra* note 2; Solomon, *Going Private: Business Practices, Legal Mechanics, Judicial Standards and Proposals for Reform*, 25 BUFFALO L. REV. 141, 158 (1975).

48. For two recent cases giving broad scope to *Singer*, see *Young v. Valhi, Inc.*, 382 A.2d 1372 (Del. Ch. 1978) (proposed long-form cash-out merger between Valhi and its subsidiary enjoined because Valhi's parent corporation, Contran, breached its duty of fairness in proposing the

Health Policy—Professional Standards Review Organization Oversight of Ambulatory Care: Can HEW Soften the Blow?

The Medicare¹ and Medicaid² programs, created in 1965 by Congress³ in an effort to make crucial health care services available to those segments of society least able to afford them, have become increasingly expensive to fund due primarily to the precipitously rising cost of health care.⁴ Recently, another disturbing inflationary force has been the subject of media coverage⁵ and congressional concern—fraud and abuse on the parts of both the providers and the beneficiaries of medical services. After finding substantial evidence demonstrating that health care providers participating in Medicare and Medicaid have frequently and profitably employed a number of fraudulent and abusive practices, Congress passed the Medicare-Medicaid Antifraud and Abuse Amendments⁶ in a comprehensive effort to rid the health care delivery system and the federal budget of these wasteful and often unsavory occurrences.⁷

In so doing, Congress placed particular emphasis on the need to monitor the health care services provided by “Medicaid mills”—usually inner-city group practice facilities owned and operated by profit motivated entrepreneurs—to eliminate a number of the fraud-

merger as part of an effort to circumvent a Valhi charter provision inhibiting Valhi's ability to merge with Contran), and *Kemp v. Angel*, 381 A.2d 241 (Del. Ch. 1977) (short-form merger enjoined because of allegations that parent obtained its over 90% holding in subsidiary as result of false representations in tender offer).

1. 42 U.S.C.A. §§ 1395-1395nn (West 1974 & Cum. Supp. 1978).

2. *Id.* §§ 1396-1396k.

3. Social Security Amendments of 1965, Pub. L. No. 89-97, §§ 102(a), 121(a), 79 Stat. 286.

4. Between 1965 and 1974, the cost of medical care in the United States doubled. Rogers, *The Challenge of Primary Care*, in *DOING BETTER AND FEELING WORSE* 81, 89 figure 4 (J. Knowles ed. 1977).

5. Two separate editions of the CBS television news show “60 Minutes” presented documentation illustrating such fraudulent practices as the rendering of unnecessary care, over-billing, billing for services never rendered, and bribery and kickback schemes in laboratory-physician relations.

6. Medicare-Medicaid Antifraud and Abuse Amendments of 1977, Pub. L. No. 95-142, 91 Stat. 1175 (codified in scattered sections of 42 U.S.C.A. (West Cum. Supp. 1978)).

7. See generally H.R. REP. No. 393, 95th Cong., 1st Sess. (1977).

ulent and abusive practices known to flourish there.⁸ The method chosen by Congress to alleviate these problems is elaborate and comprehensive. Professional Standards Review Organizations (PSROs),⁹ previously responsible only for monitoring the level of care provided Medicare and Medicaid beneficiaries in institutions,¹⁰ will now be required to review the Medicare- and Medicaid-reimbursed services rendered in all noninstitutional (ambulatory) care settings with respect to the necessity, appropriateness, and quality of the services provided.¹¹ Requests to the Secretary of Health, Education and Welfare (HEW) by PSROs to review "shared health facilities,"¹² a subset of ambulatory care facilities under the bill and defined to include Medicaid mills,¹³ are to be given priority by the Secretary¹⁴ in order to expedite PSRO review of the "mills." This review mechanism is intended to curtail the over-utilization of services for which Medicare or Medicaid reimbursement is sought.

The extension of PSRO review into the publicly funded ambulatory care field effects significant change. Review of the quality and necessity of medical care provided in the publicly funded ambulatory care field has hitherto been carried out on an optional basis only.¹⁵ Generally, ambulatory care providers have been reimbursed on a fee-for-service basis regardless of the medical necessity or quality of the services rendered. While the review that was conducted was sufficient to ensure that flagrant abuse and fraud were not left wholly unde-

8. See *id.* pt. 2, at 45-46.

9. PSROs review the necessity and quality of health care for which Medicare or Medicaid reimbursement is sought. They are composed of members of the local medical profession who apply local standards of quality and necessity in making review determinations. PSROs deny reimbursement for unnecessary services and rectify quality deficiencies. See notes 18-33 and accompanying text *infra*.

10. H.R. REP. NO. 393, *supra* note 7, pt. 1, at 52.

11. 42 U.S.C.A. § 1320c-4(g)(2) (West Cum. Supp. 1978). Fully operational (designated) PSROs are required by this provision to begin ambulatory care review within two years after becoming designated. *Id.* See also H.R. REP. NO. 453, 95th Cong., 1st Sess. 42 (1977) (conference committee report). Though no PSROs have yet been designated, see note 17 and accompanying text *infra*, the 108 PSROs with "conditional" designations are required to reach fully designated status within four years by the new law. See 42 U.S.C.A. § 1320c-3(b) (West Cum. Supp. 1978). Therefore, a large number of PSROs will be conducting ambulatory care review by 1984.

12. 42 U.S.C.A. § 1301(a)(9) (West Cum. Supp. 1978).

13. H.R. REP. NO. 393, *supra* note 7, pt. 1, at 52-53.

14. 42 U.S.C.A. § 1320c-4(g)(2) (West Cum. Supp. 1978).

15. See Social Security Amendments of 1972, Pub. L. No. 92-603, § 1155(g), 86 Stat. 1329 (amended 1977) (current version codified at 42 U.S.C.A. § 1320c-4(g)(2) (West Cum. Supp. 1978)).

tected,¹⁶ most efforts to monitor the necessity and quality of care were directed toward institutional care. PSRO review of ambulatory care represents a new and pervasive intervention in an area receiving a large percentage of Medicare and Medicaid funds.¹⁷ The opportunity for

16. See, e.g., Kavalier, *People, Providers and Payment—Telling It How It Is*, 59 AM. J. PUB. HEALTH 825 (1969).

17. In view of the unsettled state of ambulatory care review, the basis of congressional belief that PSROs can effect cost reductions and quality control in the ambulatory care sector warrants scrutiny. The most compelling justification Congress could have had for passing the amendments would have been documented success of PSRO review in the institutional care setting—but no such documentation exists. Of the 203 PSRO areas nationwide, there are 108 conditional PSROs and 64 with planning status. In fact, as of October 1977, no PSRO had yet achieved fully operational status. S. Laudicina & A. Schneider, *The Medicare-Medicaid Anti-Fraud and Abuse Amendments of 1977: Implications for the Poor*, n.40 (National Health Law Program, Inc., 1977). Physician cooperation, essential to this voluntary participation program, has been extended only grudgingly at best, *Medicare-Medicaid Anti-fraud and Abuse Amendments: Joint Hearing Before the Subcomm. on Health of the House Comm. on Ways and Means and the Subcomm. on Health and the Environment of the House Comm. on Interstate and Foreign Commerce*, 95th Cong., 1st Sess. 255, 268-69 (1977) (statement of Dr. Edgar T. Beddingfield, Jr., for American Medical Association) [hereinafter cited as *Hearing*], even after significant efforts by HEW to mollify the profession. The primary purpose of the original PSRO legislation was cost containment. J. BLUM, P. GERTMAN & J. RABINOW, *PSROs and THE LAW* 20 (1977) [hereinafter cited as J. BLUM]. In a publication aimed at practitioners, however, HEW emphasized that the primary goal was quality control. DEPT OF HEALTH, EDUCATION AND WELFARE, PUB. NO. (05) 74-50001 (1973), reprinted in 2 MEDICARE AND MEDICAID GUIDE (CCH) 5227 (1974). Presumably, this latter goal was more palatable to the profession, which is opposed to regulation of any sort. Experts agree that any attempt at this time to evaluate the effectiveness of PSROs in reducing costs or upgrading quality would be premature. *Hearing, supra* at 418-19 (statement of National Council of State Welfare Administrators, American Public Welfare Association), 321-22 (statement of Dr. Anthony Robbins); see J. BLUM, *supra* at 204-05; Price, Katz & Provence, *Advocate's Guide to Utilization Review*, 71 CLEARINGHOUSE REV. 318 (1977). Moreover, Congress at no point expresses sufficient satisfaction with PSRO efforts to date to justify the broad expansion of PSRO utilization effected by the 1977 amendments. The legislative history, however, offers no other reason for their enactment.

The legislative history does evince concern on the part of a number of groups that the traditional PSRO function of cost and quality control would be injudiciously altered by the amendments. E.g., *Hearing, supra* at 5 (statement of Dr. Tim Lee Carter who cosponsored the bill), 382 (statement of Dr. Louis Finney for American Association of Neurological Surgeons), 255, 268 (statement of Dr. Edgar T. Beddingfield, Jr. for AMA Council of Legislation). Indeed, the priority given to shared health facility review, see notes 12-14 and accompanying text *supra*, coupled with the requirement that PSROs make data available to federal and state Medicare and Medicaid agencies responsible for controlling fraud and abuse, 42 U.S.C.A. § 1320c-15(b)(1) (West Cum. Supp. 1978), indicates a congressional intent to accord PSROs an investigative aspect foreign to the original PSRO cost control mandate. The report of the House of Representatives accompanying the amendments, however, disclaims any such intent. H.R. REP. NO. 393, *supra* note 7, pt. 1, at 53. More to the point, the extension of mandatory PSRO review to all ambulatory care services, rather than solely to those rendered in the "mills," is not explained by the "investigative arm" hypothesis.

Although PSROs have not been proven effective, the literature on them indicates a consensus among observers that, even before the most recent amendments, it was likely that PSROs would figure instrumentally in Congress' plans for establishing a national health insurance scheme, e.g., Havighurst & Blumstein, *Coping With Quality/Cost Trade-Offs in Medical Care: The Role of PSROs*, 70 NW. U.L. REV. 6, 8 (1975); Kennedy, *Preface: Public Concern and Federal Intervention in the Health Care Industry*, 70 NW. U.L. REV. 1, 5 (1975), possibly becoming the sole program responsible for utilization review and quality assurance in the entire health care sector. See, e.g.,

beneficial change, both in the PSRO program and in the nation's health care delivery system, is great. Conversely, however, the potential for serious harm caused by clumsy PSRO intervention in ambulatory care is also substantial.

PSROs were created by the Social Security Amendments of 1972¹⁸ in a congressional effort to contain the spiraling costs of Medicare and Medicaid.¹⁹ The 1972 Act requires the Secretary of HEW to "establish . . . [geographical] areas with respect to which [PSROs] may be designated,"²⁰ and then to enter into a contract with a "qualified organization"²¹ in each area, designating that organization as a "conditional" PSRO.²² To qualify, an organization seeking PSRO designation from HEW must be nonprofit, composed of a "substantial portion" of the licensed doctors of medicine and osteopathy in the PSRO's designated area, and must submit to HEW a "formal plan for the orderly assumption and implementation" of statutory review responsibilities.²³ After receiving a "conditional" designation, a PSRO is to implement its plan and become fully operational (conducting all required review) within four years,²⁴ whereupon it can attain "operational" status and be considered a fully designated PSRO.

"In order to promote the effective, efficient, and economical delivery of health care services of proper quality,"²⁵ PSROs are required to determine whether services for which Medicare or Medicaid reimbursement is sought are medically necessary and conform to pro-

Greenburg, *PSRO—On the Way, But to Where*, 20 NEW ENGLAND J. MED. 1493, 1493 (1974). This would obviously represent a prodigious undertaking presenting formidable transitional and organizational problems. Perhaps, therefore, the 1977 amendments contain a hidden agenda—the gradual implementation of PSRO expansion in an effort to cushion the impact on the health care field and the nation's economy of an ultimately all-inclusive health care review.

18. Social Security Amendments of 1972, Pub. L. No. 92-603, §§ 1155-1170, 86 Stat. 1329. PSROs are regulated by four sources: the statute, U.S.C.A. §§ 1320c to 1320c-22 (West 1974 & Cum. Supp. 1978); regulations, 42 C.F.R. § 101 (1976); the program manual, DEP'T OF HEALTH, EDUCATION AND WELFARE, PSRO PROGRAM MANUAL (1974) [hereinafter cited as PSRO PROGRAM MANUAL]; and transmittal letters issued by the Bureau of Quality Assurance, which is part of HEW. The latter two sources, though not binding on PSROs because they are not promulgated in compliance with the Administrative Procedure Act, 5 U.S.C. §§ 552-553 (1976), are made binding by the PSRO-HEW contract. J. BLUM, *supra* note 17, at 49; see note 48 *infra*. See generally J. BLUM, *supra* note 17, at 19-53.

19. See 42 U.S.C. § 1320c (Supp. V 1975) (declaration of purpose).

20. *Id.* § 1320c-1(a).

21. *Id.*

22. *Id.*

23. 42 U.S.C.A. § 1320c-1(b) (West Cum. Supp. 1978).

24. Originally, the conditional designation period was not to exceed 24 months. Social Security Amendments of 1972, Pub. L. No. 92-603, § 1154(b), 86 Stat. 1329. The new law extends that period to 48 months. 42 U.S.C.A. § 1320c-3(b) (West Cum. Supp. 1978).

25. 42 U.S.C. § 1320c (Supp. V 1975).

fessional standards of quality.²⁶ These decisions are to be made by applying "professionally developed" norms²⁷ and criteria²⁸ based upon "typical patterns of practice in [the PSRO] region."²⁹ If, on the basis of its review, a PSRO finds that some or all of the services rendered or to be rendered to a Medicare or Medicaid beneficiary were or are not medically necessary, it must deny reimbursement.³⁰ When it finds that the services have been of substandard quality, the PSRO can require the provider to undertake continuing education in order to increase its expertise,³¹ or in more serious cases, it may report the violations to HEW, which may then suspend or exclude the provider from participation in the Medicare and Medicaid programs.³²

It is apparent from this complex body of legislation that a PSRO has two distinct review responsibilities: utilization review, to determine the medical necessity of services; and quality assurance, to monitor and assure compliance with professional standards of quality. Utilization review can be thought of as establishing the maximum level of health care services that may be reimbursed under Medicare and Medicaid by asking: "What procedures and tests were used?" Quality assurance, in contrast, enforces the minimum level of care acceptable to the local members of the medical profession by asking: "What procedures and tests were *not* used?" Together, the two review procedures form a health care public accountability system³³ applying peer-developed norms and criteria to determine the adequacy and necessity of medical services provided.

PSROs are required by the 1972 statute to conduct "concurrent" utilization review of all hospital care for which reimbursement is sought.³⁴ Concurrent review is conducted while the patient is in the

26. *Id.* PSROs are also required to determine whether institutional care was or is being rendered in the appropriate setting—the least expensive setting consistent with quality care. *Id.*

27. 42 U.S.C. § 1320c-5(a) (Supp. V 1975). Norms are used in evaluating necessity. They represent the typical amount of care delivered to similar patients with similar dysfunctions. See notes 40-42 and accompanying text *infra*.

28. PSRO PROGRAM MANUAL, *supra* note 18, § 709. The criteria used in evaluating the quality of care represent either those procedures that local practitioners believe ought to be performed, or the acceptable level of success in patient health improvement. See notes 56-63 and accompanying text *infra*.

29. 42 U.S.C. § 1320c-5(a) (Supp. V 1975).

30. See 42 U.S.C.A. § 1320c-7 (West Cum. Supp. 1978).

31. J. BLUM, *supra* note 17, at 41.

32. *Id.* at 41-42.

33. See Escovitz & Zeleznick, *Health Care Accountability System*, in PSRO UTILIZATION AND AUDIT IN PATIENT CARE 232 (S. Davidson ed. 1976) (comparison and contrast of two types of PSRO review responsibilities).

34. See 42 U.S.C. § 1320c-5(d)(1) (Supp. V 1975).

hospital to determine the necessity of his admission to the facility and the necessity of his continued stay there.³⁵ Prospective review, or preadmission screening, is authorized but optional,³⁶ and consists of a determination of the necessity for elective admissions before they occur.³⁷ Retrospective review is conducted after discharge by reviewing the patient's chart or an abstract of it³⁸ only when concurrent review has not been implemented, or when it has been ineffective.³⁹

All utilization review scrutinizes the amount of care rendered a patient. Hospital utilization review by PSROs deals primarily with the length of time spent by a patient in the facility. A norm representing the typical length of stay for previous subjects in a patient's age-sex-diagnosis category is used to determine his permissible length of stay;⁴⁰ any stay lasting longer than that norm must be justified to the PSRO by the patient's attending physician.⁴¹ An analogous norm, representing the typical number of doctor visits in a patient's age-sex-diagnosis category, has been used successfully in ambulatory care utilization review to reduce the costs of care without prejudice to professional quality standards.⁴² It can therefore be reasonably anticipated that PSROs will undertake review for medical necessity of the number of doctor visits, applying norms analogous to those employed in length of stay hospital review.

It is likely that this review will be concurrent or retrospective, since prospective screening by a doctor to determine if a patient needs to see a doctor would be impractical, wasteful, and quite possibly unconstitutional.⁴³ Moreover, concurrent review in the ambulatory care setting will likely be the exception and not the rule because of practical limitations. Concurrent review of length of stay in hospitals is achieved by

35. J. BLUM, *supra* note 17, at 6-8. See generally Price, Katz & Provence, *supra* note 17.

36. See 42 U.S.C. § 1320c-4(a)(2) (Supp. V 1975).

37. J. BLUM, *supra* note 17, at 6.

38. *Id.* at 8.

39. PSRO PROGRAM MANUAL, *supra* note 18, § 707(b).

40. *Id.* § 709.15. See J. BLUM, *supra* note 17, at 316-18, for a discussion of hospital utilization review as performed by in-house utilization review committees. PSRO utilization review is identical in its essentials. *Id.* at 322.

41. J. BLUM, *supra* note 17, at 323. Permissible deviations from the norm are represented by "standards." PSRO PROGRAM MANUAL, *supra* note 18, §§ 705.2, -.24, -.26, 709.14.

42. See Sasuly & Hopkins, *A Medical Society-Sponsored Comprehensive Medical Care Plan—The Foundation for Medical Care of San Joaquin County, California*, 5 MED. CARE 234, 247 table 7 (1967).

43. Cf. *American Med. Ass'n v. Weinberger*, 522 F.2d 921 (1975) (pending trial on merits, enforcement of HEW regulations requiring hospitals participating in Medicare or Medicaid to perform review of hospital admissions within 24 hours after they occur enjoined, primarily because they endangered right of patient to receive treatment).

requiring that, in order for a patient to be reimbursed for hospital days beyond the date determined to be the norm for his age-sex-diagnosis group, a reviewer must certify before that date the necessity of an extension.⁴⁴ Analogously, when an ambulatory care patient is scheduled for a regular medical appointment with his physician, he could be told before he makes his norm-exceeding visit that Medicare or Medicaid will not pay for it, if that is the PSRO decision. Plainly, however, this can be done only when the patient is expected to return to the same physician in connection with the same illness that prompted his previous visit or visits. Except in the case of chronic or moderately serious illness when return visits to the doctor are expected, the typical illness episode will probably not be so predictable. Thus, quite often, review will of necessity be retrospective.

That being so, a significant shift in the importance given cost of care by PSRO reviewing committees may be forthcoming. In conducting concurrent review of the "necessity" of health care services before they are rendered, doctors quite correctly give considerable weight to the patient's right to receive treatment.⁴⁵ Because the PSRO decision will affect the care to be received by a particular patient, reimbursement will often be favored in those borderline cases in which the marginal benefit to the patient is small and the cost of the service great. When retrospective review is conducted, however, treatment has already been given; consequently, only the right to payment is at stake. Freed of the necessity of considering a particular patient's needs, the PSRO may be more prone to take a "macro" view of the costs and benefits of health care—the PSRO can decide the necessity of particular health care services by a dispassionate balancing of their benefits and costs, unencumbered by the natural tendency in a marginal situation to provide a particular patient all beneficial services.⁴⁶

The *PSRO Program Manual* provisions,⁴⁷ however, promulgated by HEW as binding⁴⁸ "guidelines" for PSRO operation, require that

44. See authorities cited note 35 *supra*.

45. Havighurst & Blumstein, *supra* note 17, at 59.

46. The PSRO reimbursement decision may become more akin to a policy decision about whether to relax a building code requirement, and less like the humanitarian decision to spend thousands of dollars to rescue a person trapped in a collapsed building. See *id.* PSROs can adequately safeguard physician expectations of reimbursement by resolving difficult necessity issues of first impression in their favor, while denying reimbursement prospectively to future providers rendering the service in question.

47. PSRO PROGRAM MANUAL, *supra* note 18.

48. The guidelines in the *PSRO Manual* are made binding on the PSROs through the PSRO-HEW contract. J. BLUM, *supra* note 17, at 49. This method of operating a government

retrospective review be conducted only when concurrent review is ineffective or not yet implemented.⁴⁹ It can be argued that, given the exigencies of ambulatory care delivery, concurrent review will almost always be ineffective, except in the case of chronic or moderately serious illness when patient visits can be anticipated. In addition, the restriction on retrospective review is based upon the principle that retroactive denial of payment imposes a hardship on beneficiary and provider alike, and is avoidable by use of concurrent review.⁵⁰ This consideration, however, is undoubtedly of less weight in the ambulatory care context because the cost of ambulatory care is only a small fraction of the cost of a typical hospital bill. The efficacy of the HEW restriction as applied to ambulatory care review is, therefore, questionable.

In addition to utilization review responsibilities, PSROs are required to monitor the quality of health care billed to Medicare and Medicaid. PSRO review of hospital care quality is accomplished through the use of two forms of "medical audit": profile review and Medical Care Evaluation studies (MCEs).⁵¹ Profile review is mandatory,⁵² and entails the maintenance and review of "profiles" which contain records of the covered care rendered by individual providers.⁵³ MCEs are retrospective reviews of patient charts conducted to determine whether health care practices meet current standards of acceptability.⁵⁴ Profile review can be used to identify the specific problems affecting medical quality, which in turn can be addressed by MCEs or concurrent utilization review.⁵⁵

The crucial variables in quality assurance are "criteria," predetermined elements against which the quality of care can be measured.⁵⁶ There is an ongoing and far from resolved debate over what form these criteria should assume; in particular, whether they should be process criteria, specifying procedures to be followed by the provider, or out-

program has been severely criticized for its failure to ensure public input into the PSRO regulation process. See, e.g., Willett, *PSRO Today: A Lawyer's Assessment*, 292 NEW ENGLAND J. MED. 340, 340-41 (1975).

49. See PSRO PROGRAM MANUAL, *supra* note 18, § 707(b).

50. See generally S. LAW, BLUE CROSS: WHAT WENT WRONG? 115-44 (1974).

51. J. BLUM, *supra* note 17, at 29-31; Price, Katz & Provence, *supra* note 17, at 322.

52. 42 U.S.C. § 1320c-4(a)(4) (Supp. V 1975).

53. *Id.*

54. PSRO PROGRAM MANUAL, *supra* note 18, § 705.31.

55. Price, Katz & Provence, *supra* note 17, at 322.

56. PSRO PROGRAM MANUAL, *supra* note 18, § 709; Price, Katz & Provence, *supra* note 17, at 323.

come criteria, measuring the ultimate effect on patients' health of the care rendered.⁵⁷

Process criteria are professionally recognized procedures to be followed in diagnosing and treating specific symptoms or conditions.⁵⁸ Their use is justifiable on the assumption that the best way to ensure the health of patients is to require that all the recognized procedures for diagnosis and treatment be followed in each case. Procedures used as process criteria, however, need not be validated by clinical tests or studies establishing their efficacy in improving patients' health.⁵⁹ Consequently, process criteria have been formally applied in evaluating the "quality" of care even though the procedures required have not been demonstrated to be efficacious in improving patients' conditions. Process criteria are, however, easy to apply in the hospital setting, where all tests and treatments administered to a patient are recorded

57. This so-called outcome/process debate has carried over to the ambulatory care quality assurance field, there to join a myriad of other problems yet to be resolved by those employing this infant discipline. See *Hearing, supra* note 17, at 154 (statement of Dr. John Bussman). See generally Christoffel & Loewenthal, *Evaluating the Quality of Ambulatory Health Care: A Review of Emerging Methods*, 15 MED. CARE 877 (1977). For example, care is frequently rendered despite the lack of a specific diagnosis to which procedure-or outcome-oriented criteria may be applied. Physicians lack control over patient adherence to instructions outside the office, thus blurring the correlation between care provided and the health of the patient. Incomplete treatment records hinder medical audit. Finally, there remain significant problems in collecting and standardizing data. *Id.* at 879-82. Existing ambulatory care quality assurance programs have done little toward solving these and other problems, and there is no consensus on what the most efficient, feasible and productive methods are for doing so. 1 N. WHITE, M. RYLAND, G. GIEBINK, D. MCCONATHA & A. TOMAN, *AMBULATORY CARE QUALITY ASSURANCE PROJECT 41* (1976). An exhaustive bibliography of the ambulatory care quality assurance literature may be found in 3 *id.*

58. Christoffel & Loewenthal, *supra* note 57, at 885-86. See generally Williamson, *Evaluating Quality of Patient Care: A Strategy Relating Outcome and Process Assessment*, 218 J.A.M.A. 564 (1971). For an example of a quality audit employing process criteria exclusively, see B. PAYNE, *THE QUALITY OF MEDICAL CARE: EVALUATION AND IMPROVEMENT* (1976). A list of items to be checked in patient history was composed by four panels of Hawaii physicians, symptoms to be discovered, and treatment to be rendered for a number of disorders. Each of these criteria was weighted according to its importance to the patient's health, and the weighted sum of the criteria met by a physician or group of physicians yielded a "Physician Performance Index" representing the quality of care provided. *Id.* at 20-28.

59. Indeed, serious impediments to validation testing of many procedures make validation impossible. See McDermott, *Evaluating The Physician and His Technology*, in *DOING BETTER AND FEELING WORSE, supra* note 4, at 135, 148-53. The PSRO PROGRAM MANUAL, *supra* note 18, requires that MCE criteria be based first on scientific evidence of a procedure's efficacy and then on expert judgment. *Id.* § 705.35(a). In a study by Brook and Appel, process criteria based on expert judgment were applied to a group of 296 patients with urinary tract infections or ulcerated gastric or duodenal lesions. The results showed that, while only 1.4% of the patients received adequate care under explicit-process scrutiny (and 23.3% under implicit-process scrutiny), 63% experienced satisfactory outcomes of treatment. Brook & Appel, *Quality-of-Care Assessment: Choosing A Method For Peer Review*, 288 NEW ENGLAND J. MED. 1323, 1327 (1973). It has been noted that "many widely accepted therapies have never been subjected to randomized, controlled clinical trials to establish their efficacy in improving patients' health." Havighurst & Blumstein, *supra* note 17, at 29; accord, Christoffel & Loewenthal, *supra* note 57, at 884.

using a uniform system.⁶⁰

Outcome criteria, on the other hand, seek to measure the effect on patients' health of the diagnostic and therapeutic procedures employed by measuring the incidence of post-treatment mortality, morbidity, physical and psychological impairment, and ability to function normally.⁶¹ Even with short-term, disease-specific outcome criteria—those that evaluate the effects of care on specific dysfunctions observable within a year after treatment—collection of data must be accomplished by the difficult task of follow-up surveys of former patients. Nevertheless, these outcome criteria are preferable to process criteria due to the paucity of scientific evidence substantiating the efficacy of many routine procedures,⁶² and because of the usefulness of outcome criteria in comparing the effectiveness of alternative modes of and settings for treatment of various illnesses.⁶³ Finally, the logic of outcome criteria—that the best way to assure good results of care is to measure them directly—is persuasive.

Although there may be good reason for preferring the convenience of process- over outcome-oriented criteria in the hospital setting, when concerned with ambulatory care different considerations must come into play to account for the unique circumstances of this latter type of care. (For example, the ease of data collection in the process approach is absent in the ambulatory care setting, in which no uniform system is in widespread use.⁶⁴) In choosing between the two types of criteria, policy-makers at HEW should consider the differences between in-patient and ambulatory care goals and methodologies, the advances which may be expected to be achieved in providing satisfactory ambulatory care, and the role ambulatory care will play in the future of the health care delivery system.

Quality assurance criteria should be sensitive to the effects on patient welfare of all aspects of health care. Nontechnical factors play a crucial role in the effect of care on a patient's health, particularly in the

60. Christoffel & Loewenthal, *supra* note 57, at 881.

61. See generally Brook, Davies-Avery, Greenfield, Harris, Lelah, Solomon & Ware, *Assessing the Quality of Medical Care Using Outcome Measures: An Overview of the Method*, 15 MED. CARE, Supp. No. 9, Sept. 1977, at 1, 9 table 9.

62. See note 59 and accompanying text *supra*.

63. Process criteria, by which the quality of care is judged according to its conformance to model treatment procedures, are inapplicable for this purpose. PSRO PROGRAM MANUAL, *supra* note 18, mentions process criteria, *id.* § 705.35(a), and outcome criteria, *id.* § 705.35(d) as appropriate methods of quality review, but expresses no preference for either.

64. Christoffel & Loewenthal, *supra* note 57, at 879.

ambulatory care setting.⁶⁵ The ability of a physician to establish a rapport with his patient and to gain his confidence and trust is probably as important a factor in inducing a patient to follow a physician's advice after he leaves the office (a problem peculiar to ambulatory care) as is the patient's comprehension of the seriousness of his condition. Without continuity of care, in which the ongoing responsibility for the health of a patient remains with the same physician or group of physicians, this crucial rapport is difficult to establish.⁶⁶ Continuity of care is facilitated by the ability of a doctor or health facility to provide a comprehensive array of services. In a survey sample of hospital outpatient facilities, fragmentation of special services into separate departments was cited, along with a lack of continuity of care, as being a primary reason for substandard care.⁶⁷ With inpatient treatment, these problems cannot arise.

Process criteria, however, fail to give sufficient weight to this particularly significant aspect of health care effectiveness. If the tests and treatments performed at two different ambulatory care facilities are identical, process criteria would indicate that the facilities are providing care of equal quality. Yet one facility, because of its poor organization or the inability of its doctors to gain the confidence of their patients, might fail dismally to improve or maintain the health of its patients. Outcome criteria, on the other hand, could readily identify the deficient facility as a target for in-depth study and its failings could then be identified and remedied.

Finally, the application of process criteria to a facility excelling in the nontechnical aspects of care could easily result in the institution of "defensive medicine" tactics⁶⁸ in an effort to gain for that facility the malpractice immunity offered by the 1972 amendments on condition of adherence to PSRO criteria,⁶⁹ and to avoid PSRO rebuke or corrective sanctions.⁷⁰ In undertaking such practices the facility would be

65. Cf. Rogers, *supra* note 4, at 82 (primary care is concerned with psychological as well as physical aspects of illness). The primary care provider is the point of first contact between the patient and the health care system. Additionally, the majority of ambulatory patients suffer from disorders of lesser physical severity, indicating the greater relative importance of psychological factors in the eventual outcome of care.

66. See *id.* at 81.

67. BIO-DYNAMICS, INC., A STUDY OF SELECTED INNOVATIVE HOSPITAL PROGRAMS IN AMBULATORY CARE 12-28 (1974).

68. See McDermott, *supra* note 59, at 139.

69. See 42 U.S.C. § 1320c-16(c) (Supp. V 1975). See generally Comment, *PSRO: Malpractice Liability and the Impact of the Civil Immunity Clause*, 62 GEO. L.J. 1499 (1974).

70. See notes 31 & 32 and accompanying text *supra*.

performing procedures that its experience has shown could be supplanted by less expensive (or more effective) measures. The result would inevitably be a disinclination to adopt innovative techniques of organization or treatment in favor of continued—and perhaps unjustified—reliance on the prescribed procedures.⁷¹

Research and development in health care delivery methodologies must be fostered by PSROs, not discouraged, if the program is successfully to aid in the development of a satisfactory health care system. In recent years, the ambulatory care sector has assumed a primary role in exploring ways to improve health while cutting costs. Preventive screening can result in a dramatic reduction of the incidence of serious illness and days of hospitalization.⁷² Similarly, maternal and infant care treatment centers are invaluable in reducing infant mortality.⁷³ Further, efforts to employ the learning of the behavioral and social sciences in ambulatory care are soon to be underway.⁷⁴ Finally, Health Maintenance Organizations (HMOs), as well as other prepaid group health care plans, are of special concern because they provide an important competitive alternative to fee-for-service providers. Because they are funded on a prepaid basis, they have only a limited amount of funds available for financing health care delivery. HMOs therefore have a strong economic incentive to develop low-cost alternatives to traditional, fee-for-service developed techniques.⁷⁵

All of these innovations hold out the prospect of improving the quality of ambulatory care delivery at reduced cost. More importantly, they offer ways of avoiding costly hospitalization at a time when such alternatives are sorely needed.⁷⁶ The PSRO program should

71. This undesirable phenomenon, commonly known as "cookbook medicine," results from rigid application of process criteria without regard to whether the processes are proven efficacious or not. See J. BLUM, *supra* note 17, at 77-78. This stifling effect on innovation is manifested in two ways. First, by requiring that certain procedures be used, alternative methods for treating or diagnosing the same condition are discarded, regardless of their outcome effectiveness. Second, the more procedures are required, the less resources are available to fund alternative programs such as preventive screening and maintenance, whose aggregate benefit to the population served by a facility and to the entire health care delivery system may far exceed that of the prescribed practice.

72. Screening of children for rheumatic fever in Baltimore caused a 60% drop in the incidence of that disease. Rogers, *supra* note 4, at 88.

73. In Omaha, Nebraska, these centers accomplished a 60% reduction in infant mortality in a five-year period. *Id.*

74. *Id.* at 102; McDermott, *supra* note 59, at 156.

75. See Havighurst & Bovbjerg, *Professional Standards Review Organizations and Health Maintenance Organizations: Are They Compatible?*, 1975 UTAH L. REV. 381.

76. Between 1965 and 1974, the cost of medical care rose approximately 100%. In that same period, the cost of a semiprivate hospital room rose 166%. Rogers, *supra* note 4, at 89 figure 4.

respect these trends,⁷⁷ allow them to develop, and where feasible, provide incentives for their proliferation. Excessive or rigid application of process criteria in PSRO quality audits could unwisely divert limited resources from innovative programs as well as hinder the development of alternative technical and nontechnical skills in ambulatory care.⁷⁸ Given the significance of the public health care sector,⁷⁹ and the magnitude of national health care expenditures,⁸⁰ clumsy PSRO activity in the ambulatory care area could have far-reaching negative economic and social effects. Conversely, by careful implementation of a national policy restricting the use of process criteria to appropriate circumstances,⁸¹ and by promotion of the general use of retrospective utilization review,⁸² HEW could effect major beneficial changes in the health care delivery system.

SAUL LOUIS MOSKOWITZ

77. "Primary ambulatory care with an emphasis on prevention, diagnostic screening, referral, preventive maintenance, and health education constitutes the wave of the future in medical care delivery." C. OAKES, *THE WALKING PATIENT AND THE HEALTH CRISIS* 325 (1973).

78. Senator Edward M. Kennedy has warned that PSRO standards, "once defined and articulated, must not become inflexible, thereby constituting barriers to innovation and evolution in the provision of health care." Kennedy, *supra* note 17, at 3.

79. In 1975 public expenditures for health and medical care totalled \$50 billion. S. AXELROD, A. DONABEDIAN & D. GENTRY, *MEDICAL CARE CHART BOOK* 107 (rev. 6th ed. 1976).

80. In 1975, \$118.5 billion dollars were spent on health and medical care in the United States. *Id.*

81. One of the primary responsibilities of the ambulatory care provider is to identify those cases that, though innocent in appearance, are in fact very serious and call for immediate treatment. Rogers, *supra* note 4, at 82. A skeletal set of diagnostic process criteria are required to assure that these cases are detected. Additionally, those procedures whose efficacy has been scientifically verified, and whose benefits clearly outweigh the costs engendered by their application, should be used as process criteria. This sensible method of criteria development was first suggested in Williamson, *supra* note 58, at 564. The process criteria thus employed could be referred to as "essential" criteria as opposed to "optimal" criteria. See Christoffel & Loewenthal, *supra* note 57, at 887.

82. See notes 44-50 and accompanying text *supra*.

