UNC SCHOOL OF LAW

NORTH CAROLINA LAW REVIEW

Volume 42 | Number 2 Article 6

2-1-1964

Notes and Comments

North Carolina Law Review

NOTES AND COMMENTS

Constitutional Law—Criminal Law—Habeas Corpus—The 1963 Trilogy

A merely representative list, not intended to be exhaustive, of the allegations of denial of due process in violation of the fourteenth amendment which the Supreme Court has deemed cognizable on habeas would include jury prejudice,[1] use of coerced confessions,[2] the knowing introduction of perjured testimony by the prosecution,[3] mob domination of the trial,[4] discrimination in jury selection[5] and denial of counsel.[6] And the currently expanding concepts of what constitutes due process of law will in the future present an even greater variety of situations in which habeas corpus will lie to test the constitutionality of state criminal proceedings.[7]

In 1963 the Supreme Court of the United States handed down three decisions which will greatly increase the importance of the writ of habeas corpus as a means of protecting the constitutional rights of those convicted of crimes. The first of these, *Fay v. Noia*,[8] deals with the availability of federal habeas corpus relief to a person who has been convicted of a crime in a state court. *Townsend v. Sain*[9] attempts to redefine the situations in which a person who has been convicted of a crime in a state court has a right to an evidentiary hearing in the federal courts upon submitting an application for habeas corpus. Finally, *Sanders v. United States*[10] deals with the right of a person who has been convicted of a crime in the federal

[1] Irwin v. Dowd, 366 U.S. 717 (1961).
[2] Brown v. Allen, 344 U.S. 443 (1953).
[3] Mooney v. Holohan, 294 U.S. 103 (1935).
[4] Moore v. Dempsey, 261 U.S. 86 (1923).
[5] Brown v. Allen, 344 U.S. 443 (1953).
[6] Wade v. Mayo, 334 U.S. 672 (1948).
[7] For example, the Court has recently overruled Betts v. Brady, 316 U.S. 455 (1942), in Gideon v. Wainright, 372 U.S. 335 (1963), holding that due process demands that indigent state criminal defendants be provided with counsel. And in an earlier case, Mapp v. Ohio, 367 U.S. 643 (1961), it was held that due process is violated by the use of illegally seized evidence in state criminal prosecutions.
[8] 372 U.S. 391 (1963).
[9] 372 U.S. 293 (1963).
[10] 373 U.S. 1 (1963).

courts to a second or successive hearing when he claims that he has been deprived of his constitutional rights.

I. Fay v. Noia*

Noia, Caminito and Bonino were taken into custody for questioning concerning a murder committed during an attempted robbery. They were held incommunicado, questioned by officers working in relays, falsely identified by three detectives posing as witnesses to the crime, and given unheated, unfurnished jail cells. Later, when Noia and Caminito were placed in the same cell, Noia suggested that they confess to escape further harassment, in the belief that the confessions would later be excluded as evidence due to coercion. The confessions were signed, and only then was the trio taken before a magistrate for arraignment.[11]

The trial court judge permitted the jury to pass on the question of coercion, and the issue was decided adversely to the defendants. Caminito and Bonino took direct appeals, but were unsuccessful in both the Appellate Division of the New York Supreme Court[12] and the New York Court of Appeals.[13] Caminito twice filed motions to reargue in the New York Court of Appeals without success.[14] He applied to the United States Supreme Court for certiorari following the second denial, which was likewise unsuccessful.[15] Bonino's motion to reargue was also denied,[16] as was his application for a writ of certiorari.[17]

Caminito then sought habeas corpus from the federal district court, which refused to issue the writ.[18] The Second Circuit Court of Appeals, however, reversed, sustaining the claim that the confession had been secured in violation of the fourteenth amendment, and directed the State to discharge him from custody or give him a new

* This portion of the *Note* was contributed by Robert G. Baynes.

[11] A complete statement of the circumstances surrounding the arrest and interrogation of the three men may be found in United States *ex rel.* Caminito v. Murphy, 222 F.2d 698 (2d Cir. 1955).

[12] State v. Bonino, 265 App. Div. 960, 38 N.Y.S.2d 1019 (1942); State v. Caminito, 265 App. Div. 960, 38 N.Y.S.2d 1019 (1942).

[13] State v. Bonino, 291 N.Y. 541, 50 N.E.2d 654 (1943).

[14] State v. Caminito, 297 N.Y. 882, 79 N.E.2d 277 (1948); State v. Caminito, 307 N.Y. 686, 120 N.E.2d 857 (1954).

[15] Caminito v. New York, 348 U.S. 839 (1954).

[16] State v. Bonino, 296 N.Y. 1004, 73 N.E.2d 579 (1947).

[17] Bonino v. New York, 333 U.S. 849 (1948).

[18] United States *ex rel.* Caminito v. Murphy, 127 F. Supp. 689 (N.D.N.Y. 1955).

trial.[19] After Caminito's release, Bonino moved to reargue his appeal in the New York Court of Appeals, and his conviction was also set aside and a new trial ordered on the ground that it was unconstitutionally procured.[20] In all probability, neither Caminito nor Bonino will ever be retried since the State presented no evidence other than the confessions, and there is little possibility of obtaining new evidence concerning a crime committed in 1942.

Following the release of his co-defendants, Noia, who had not appealed his original conviction, made an application to the sentencing court in the nature of *coram nobis,*[21] and his conviction was set aside;[22] however, the Appellate Division reversed[23] and the New York Court of Appeals affirmed.[24] A writ of certiorari was denied.[25]

Noia's next step was to apply to the federal district court for a writ of habeas corpus.[26] Relief was denied on the ground that he had failed to comply with 28 U.S.C. section 2254[27] requiring exhaustion of state remedies as a condition precedent to the granting of habeas corpus by the federal courts to a state prisoner. The Court of Appeals for the Second Circuit reversed,[28] questioning whether the statute barred habeas corpus relief when the petitioner had failed to

[19] United States *ex rel.* Caminito v. Murphy, 222 F.2d 698 (2d Cir.), *cert. denied,* 350 U.S. 896 (1955).

[20] State v. Bonino, 1 N.Y.2d 752, 152 N.Y.S.2d 298, 135 N.E.2d 51 (1956).

[21] A writ of error *coram nobis* is a remedy to bring a case before the sentencing court for review or modification due to some error of law or fact affecting the validity of the proceedings which was not brought into issue at the trial. It challenges the validity of petitioner's conviction for matters extraneous to the record. *In re* Taylor, 230 N.C. 566, 53 S.E.2d 857 (1949); see generally, 24 C.J.S. *Criminal Law* § 1606 (1961).

[22] State v. Noia, 3 Misc. 2d 447, 158 N.Y.S.2d 683 (1956).

[23] State v. Noia, 4 App. Div. 2d 698, 163 N.Y.S.2d 796 (1957).

[24] State v. Caminito, 3 N.Y.2d 596, 170 N.Y.S.2d 799, 148 N.E.2d 139 (1958).

[25] Noia v. New York, 357 U.S. 905 (1958).

[26] United States *ex rel.* Noia v. Fay, 183 F. Supp. 222 (S.D.N.Y. 1960).

[27] 28 U.S.C. § 2254 (1948). This statute provides: "An application for a writ of habeas corpus in behalf of a person in custody pursuant to the judgment of a State court shall not be granted unless it appears that the applicant has exhausted the remedies available in the courts of the State, or that there is either an absence of available State corrective process or the existence of circumstances rendering such process ineffective to protect the rights of the prisoner. An applicant shall not be deemed to have exhausted the remedies available in the courts of the State, within the meaning of this section, if he has the right under the law of the State to raise, by any available procedure, the question presented."

[28] United States *ex rel.* Noia v. Fay, 300 F.2d 345 (2d Cir. 1962).

exhaust state remedies no longer available to him at the time of his petition, and holding the statute inapplicable due to exceptional circumstances.[29] The court of appeals also rejected the contention that New York's refusal to grant *coram nobis* after the time for appeal had lapsed was an adequate and independent ground of decision due again to the exceptional circumstances. Finally, that court held that no waiver of the constitutional claim could be inferred from Noia's failure to appeal.

The Supreme Court granted certiorari[30] and held:

> (1) Federal courts have *power* under the federal habeas corpus statute to grant relief despite the applicant's failure to have pursued a state remedy not available to him at the time he applies; the doctrine under which state procedural defaults are held to constitute an adequate and independent state law ground barring direct Supreme Court review is not to be extended to limit the power granted the federal courts under the federal habeas statute. (2) Noia's failure to appeal was not a failure to exhaust "the remedies available in the courts of the State" as required by § 2254; that requirement refers only to a failure to exhaust state remedies still open to the applicant at the time he files his application to habeas corpus in the federal court. (3) Noia's failure to appeal cannot under the circumstances be deemed an intelligent and understanding waiver of his right to appeal....[31]

These three doctrinal hurdles to federal jurisdiction—the rule requiring exhaustion of state remedies, the doctrine of waiver and the doctrine of independent and adequate state grounds for decision—will be treated separately.

A. The Exhaustion Requirement

The statute[32] requiring the exhaustion of state remedies as a condition precedent to an application for federal habeas corpus relief

[29] The exceptional circumstances were "the undisputed violation of a significant constitutional right, the knowledge of this violation brought home to the federal court at the incipiency of the habeas corpus proceeding so forcibly that the state made no effort to contradict it, and the freedom the relator's codefendants now have by virtue of their vindications of the identical constitutional right...." United States *ex rel.* Noia v. Fay, 300 F.2d 345, 362 (2d Cir. 1962).

[30] Fay v. Noia, 369 U.S. 869 (1962).

[31] Fay v. Noia, 372 U.S. 391, 398-99 (1963).

[32] See note 27 *supra.*

on behalf of a state prisoner is a codification of earlier case law.[33] Those decisions establish that the rule is not inflexible[34] and is one which should yield always to exceptional circumstances.[35] In addition, the statute explicitly excuses a failure to exhaust when "there is either an absence of available State corrective process or the existence of circumstances rendering the process ineffective to protect the rights of the prisoner."[36]

The exhaustion requirement is based on two policy considerations: first, it is dictated by the exigencies of federalism (the doctrine whereby the federal courts defer action on state cases until the state courts have acted);[37] second, it is necessary to prevent an influx of habeas petitions into the federal courts.[38]

Necessarily, the exhaustion requirement presupposes the existence of some adequate state post-conviction remedy to test the constitutionality of the conviction,[39] whether it be by way of appeal, habeas corpus, or a writ of error *coram nobis*. If such a remedy is unavailable, the federal district court may entertain an application for a writ of habeas corpus without further proceedings.[40] There is also federal jurisdiction when the remedy, otherwise valid, is shown to be unavailable or seriously inadequate in a particular case.[40a] Finally, the rule requiring the exhaustion of state remedies is not enforced when post-conviction remedies are discriminatorily denied the applicant in violation of the equal protection clause.[41]

A problem which arises immediately in the construction of this statute[42] is whether the exhaustion requirement applies only to those remedies still available to petitioner at the time of his application for habeas, or whether the remedies must have been exhausted during the time when they were available according to state procedure. In other words, is there a doctrine of forfeiture built into the exhaustion rule?

---

[33] *Ex parte* Hawk, 321 U.S. 114 (1944).
[34] Frisbie v. Collins, 342 U.S. 519 (1952).
[35] Wade v. Mayo, 334 U.S. 672 (1948).
[36] 28 U.S.C. § 2254 (1948).
[37] Darr v. Burford, 339 U.S. 200 (1950).
[38] Wade v. Mayo, 334 U.S. 672 (1948).
[39] Jennings v. Illinois, 342 U.S. 104 (1951).
[40] Moore v. Dempsey, 261 U.S. 86 (1923).
[40a] *Ibid.*
[41] Dowd v. United States *ex rel.* Cook, 340 U.S. 206 (1951).
[42] See note 27 *supra*.

With a reminder that the statute was a codification of then existing case law,[43] the Court in *Fay* addressed itself to the precedents bearing on this point. In *Ex parte Spencer*,[44] the Court gave a clear indication that federal relief would not be available to an applicant who had failed to exhaust the state remedies while they were still available. The same position was taken in *Frank v. Mangum*,[45] but this case may have been over-ruled by *Moore v. Dempsey*.[46] And in *Mooney v. Holohan*,[47] the Court phrased the exhaustion requirement in terms of the remedies which "may still remain open."[48] The majority in *Fay*, refusing to construe the statute as indicating a congressional intent to change the law in this regard, squarely held that the requirement is limited in application to "failure to exhaust state remedies still open to the applicant at the time he files his application in federal court."[49]

What of the situation where in a given state there is more than one procedural device by which the defendant can vindicate the claimed violation of his constitutional rights? Must he avail himself of *all* remedies before he will be deemed to have complied with the statutory admonition to exhaust state remedies, or is it sufficient that one alternative has been pursued to a conclusion?

In *Ex parte Hawk*,[50] it was suggested that federal habeas corpus would be available to a state prisoner only after all state remedies had been exhausted on the theory that so long as there remained an untried remedy, there had been no denial of due process, and therefore there was no justification for permitting the conviction to be collaterally attacked. This approach was given further impetus in a later case[51] which, though not presenting a square holding on the point, indicated that the rule should be strictly construed as requiring exhaustion of every alternative. But the Court changed its direction completely in *Wade v. Mayo*[52] by holding that to exhaust any single alternative remedy constituted compliance with the require-

[43] *Ex parte* Hawk, 321 U.S. 114 (1944).
[44] 228 U.S. 652 (1913).
[45] 237 U.S. 309 (1915).
[46] 261 U.S. 86 (1923).
[47] 294 U.S. 103 (1935).
[48] *Id.* at 115 (dictum).
[49] 372 U.S. at 435 (1963).
[50] 321 U.S. 114 (1944).
[51] Sunal v. Large, 332 U.S. 174 (1947).
[52] Wade v. Mayo, 334 U.S. 672 (1948).

ment. And, the question was finally laid to rest when *Brown v. Allen*[53] reaffirmed *Wade* on this point.

Another aspect of the exhaustion requirement which has had an inconstant career before the Supreme Court is the rule that, upon exhaustion of state remedies, the petitioner must apply unsuccessfully to the Supreme Court for certiorari before applying to the federal district court for a writ of habeas corpus, in spite of the fact that the statute speaks only of exhausting remedies still available in the state. This rule was announced in *Ex parte Hawk*[54] and was prompted by a desire to preserve the delicate balance of federal-state relations.[55] Later, there was an indication that application for certiorari would no longer be required,[56] but this liberal trend was short-lived. In *Darr v. Burford*,[57] the Court restated its holding in *Hawk*.

This additional prerequisite to federal habeas corpus for state prisoners was not really at issue in *Fay v. Noia* since Noia had petitioned for certiorari following denial of *coram nobis* relief.[58] Nevertheless, the Court expressly disapproved of this requirement on the ground that it had served in practice only to impede prompt judicial administration.[59] And though a dictum, the Court's statement makes it clear that a petition for certiorari following an adverse decision of the highest state tribunal will no longer be required as a condition precedent to federal habeas corpus.

B. Adequate Non-Federal Ground

It has long been held that the Supreme Court will decline to review those judgments of state courts which rest on adequate and independent state grounds, even though federal questions are present in the case.[60] A state ground may be deemed independent

[53] 344 U.S. 443 (1953).

[54] 321 U.S. 114 (1944).

[55] The *Fay* case does no great violence to federal-state relations. The state courts will continue to have the first opportunity to rule on alleged violations of the prisoner's federal constitutional rights. And certiorari will be available to the state to have decisions of federal district courts granting habeas corpus to state prisoners reviewed. Fay v. Noia, 372 U.S. at 438.

[56] Wade v. Mayo, 334 U.S. 672 (1948).

[57] Darr v. Burford, 339 U.S. 200 (1950).

[58] United States *ex rel.* Noia v. Fay, 183 F. Supp. 222 (S.D.N.Y. 1960).

[59] 372 U.S. at 435.

[60] See, *e.g.*, NAACP v. Alabama *ex rel.* Patterson, 357 U.S. 449 (1958); Herb v. Pitcairn, 324 U.S. 117 (1945); Fox Film Corp. v. Mueller, 296 U.S. 207 (1935).

whether it is based on substantive[61] or procedural[62] law. To be deemed adequate, a state procedural rule may not on its face hinder the exercise of federal rights[63] or be applied in an unduly burdensome manner.[64]

Noia had failed to perfect an appeal within the time specified by New York procedure. For this reason, he was denied a writ of error *coram nobis*.[65] Non-compliance with state procedural rules has been held to be an adequate state ground of decision.[66] It could be logically asserted, therefore, that there was an adequate and independent state ground for the denial of *coram nobis* sufficient to preclude direct review by the Supreme Court on certiorari. The Court expressed no opinion on this point, but held, instead, that this doctrine which limits the Court's *appellate* jurisdiction was not to be applied to restrict the federal district court's jurisdiction in an original proceeding (habeas corpus). Mr. Justice Harlan, joined by Justices Clark and Stewart, dissenting, termed this result "wholly unprecedented."[67] They were greatly disturbed by the fact that a petitioner, under the rule announced, whose application for certiorari to review the state court judgment might be denied due to a procedural default constituting an adequate state ground of decision, may nevertheless proceed immediately to petition the district court for habeas corpus. This is, in the words of Mr. Justice Harlan, "to turn habeas corpus into a roving commission of inquiry into every possible invasion of the applicant's civil rights that may ever have occurred...."[68] This criticism has obvious appeal to those who feel that the power of the federal judiciary has been extended to the point where it infringes upon that of the state. But it is deprived of its validity by the majority's holding which gives discretion to the

[61] Murdock v. Memphis, 87 U.S. (20 Wall.) 590 (1874). The question was whether or not a trust was established for the benefit of plaintiffs.

[62] Herb v. Pitcairn, 324 U.S. 117 (1945). This case involved jurisdiction of the court and the statute of limitations.

[63] Central Union Telephone Co. v. City of Edwardsville, 269 U.S. 190, 194 (1925) (clear dictum).

[64] Staub v. City of Baxley, 355 U.S. 313 (1958). A statute prohibited solicitation without a permit from the mayor and the city council.

[65] Noia v. New York, 357 U.S. 905 (1958).

[66] Daniels v. Allen, reported *sub. nom.* Brown v. Allen, 344 U.S. 443 (1953).

[67] 372 U.S. at 463.

[68] *Id.* at 469.

district judge to deny relief to an applicant who deliberately bypasses the state appellate procedure.[69]

C. Waiver

The Supreme Court declines to reverse the judgments of lower courts if it finds that the federal claim has, at some stage of the proceedings, been waived.[70] And failure to comply with state procedural requirements has been held a waiver, assuming the absence of circumstances excusing noncompliance such as official restraint of the petitioner in the exercise of his rights.[71] What has become the classic definition of waiver was enunciated in *Johnson v. Zerbst*[71a] as "an intentional relinquishment or abandonment of a known right or privilege."[72] The Court in *Fay* purported to apply this standard but held that Noia's failure to appeal could not, under the circumstances, be deemed a waiver of the alleged violation of his constitutional rights. It was said that if the habeas applicant has deliberately bypassed the state appellate procedure, for strategic, tactical or other reasons, the federal district court has discretion to deny him relief. The standard to be applied in all cases is predicated on the considered choice of the petitioner.

Had Noia appealed his conviction, reversal would have meant a new trial at which he could have been sentenced to death. Clearly, his decision not to take such an unappealing alternative, but to serve his sentence of life imprisonment, was not *merely* a strategic or tactical choice. Just as clearly, however, it was "an intentional relinquishment or abandonment of a known right or privilege"[73] and while the Court cautions against the assumption that waiver will not be found merely because there is a very real risk of a heavier penalty being imposed,[74] it relies on the fact that Noia's risk of incurring the death penalty was "palpable and indeed acute."[75]

---

[69] 372 U.S. at 438.
[70] Johnson v. Zerbst, 304 U.S. 458 (1938).
[71] Dowd v. United States *ex rel.* Cook, 340 U.S. 206 (1951).
[71a] 304 U.S. 458 (1938).
[72] *Id* at 464.
[73] *Ibid.*
[74] 372 U.S. at 440.
[75] Indeed, Noia had barely escaped the death penalty at his trial. The sentencing judge, not bound by the jury's recommendation of a life sentence, informed Noia that he accepted the jury's recommendation only because of the persuasiveness of defense counsel: "You have got a good lawyer, that is my wife. The last thing she told me this morning is to give you a chance." Fay v. Noia, 372 U.S. 391, 396 n.3.

II. Townsend v. Sain*

Another case[76] concerning the duties of federal district courts when habeas corpus is sought on the grounds that a state court conviction has denied petitioner his constitutional rights was decided with *Fay v. Noia.*[77] Petitioner's conviction of murder in the courts of Illinois was largely the result of the admission into evidence of a confession which was claimed to be involuntary.[78] The trial judge held an evidentiary hearing to determine this question at which conflicting testimony was introduced, but he made no findings of fact and did not write an opinion stating the grounds for his decision. Petitioner appealed the conviction unsuccessfully[79] and also sought post conviction relief in the Illinois courts,[79a] continuously asserting the involuntariness of his confession. He then sought habeas corpus in the federal district court, but his petition was denied without a hearing.[80] The Supreme Court reversed,[81] but on remand the court of appeals again denied a hearing, holding that on habeas corpus the inquiry of the district judge is limited to the undisputed portion of the record.[82] The Supreme Court again granted certiorari,[83] and Chief Justice Warren, speaking for a majority of five, again reversed.[84]

In *Brown v. Allen*[85] the Supreme Court laid down the following rule to guide the federal district courts in determining when an evidentiary hearing is mandatory:[86]

> When the record of the state court proceeding is before the court, it may appear that the issue turns on basic facts and that the facts

---

* This portion of the *Note* was contributed by DeWitt C. McCotter.

[76] Townsend v. Sain, 372 U.S. 293 (1963).

[77] 372 U.S. 391 (1963). See Part I *supra.*

[78] The opinion of the Supreme Court has been relied upon for a statement of these facts. See 372 U.S. at 296.

[79] People v. Townsend, 11 Ill. 2d 30, *cert. denied,* 355 U.S. 850 (1957).

[79a] This attempt is apparently unreported.

[80] United States *ex rel.* Townsend v. Sain, 265 F.2d 660 (7th Cir. 1958).

[81] Townsend v. Sain, 359 U.S. 64 (1959).

[82] United States *ex rel.* Townsend v. Sain, 276 F.2d 324 (7th Cir. 1960).

[83] Townsend v. Sain, 365 U.S. 886 (1961).

[84] Townsend v. Sain, 372 U.S. 293 (1963).

[85] 344 U.S. 443 (1953).

[86] Congress has given federal courts power to "summarily hear and determine the facts as law and justice require." 28 U.S.C. § 2243 (1958). The Supreme Court has interpreted this power to be largely within the discretion of the district court judges. Thomas v. Arizona, 356 U.S. 390 (1958); Brown v. Allen, *supra* note 85.

> have been tried and adjudged against the applicant. Unless a vital flaw be found in the process of ascertaining such facts in the state court, the district judge may accept the determination in the state proceeding and deny the application.[87]

More recently, the Court made the following statement about the applicability of that rule:

> While the district judge may, unless he finds a vital flaw in the state court proceedings, accept the determination in such proceedings, he need not deem such determinations binding, and may take testimony.[88]

In light of this language, it is easy to see that the test formulated in *Brown* was not concerned with whether the petitioner's claim of error was based on the undisputed portion of the record, and the Court in the instant case could have reversed on that reason alone. Further, testimony had been admitted at the petitioner's trial on behalf of the State which was directly contradictory to that which the State had presented at the evidentiary hearing; the issue had been whether petitioner was under the influence of a "truth serum" when he made the confession, and the doctor who administered the drug, when testifying as a State's witness, had not disclosed that the drug given to petitioner shortly before he confessed was commonly thought of as a "truth serum." On these facts it hardly seems likely that the Court was compelled to formulate new rules in order to justify a compulsory hearing.

The Court stated, though, that the test laid down in *Brown* for determining when a federal district judge must hold an evidentiary hearing was inadequate,[89] and formulated the following test to replace it:

> Where the facts are in dispute, the federal court on habeas corpus must hold an evidentiary hearing if the habeas applicant did not receive a full and fair evidentiary hearing in a state court, either at the time of the trial or in a collateral proceeding. In other words a federal evidentiary hearing is required unless the state

[87] 344 U.S. at 507 (1953).

[88] Rogers v. Richmond, 357 U.S. 220 (1958) (per curiam).

[89] "But experience proves that a too general standard—the 'exceptional circumstances' and the 'vital flaw' tests of the opinions in Brown v. Allen—does not serve adequately to explain the controlling criteria for the guidance of the federal habeas corpus courts." Townsend v. Sain, 372 U.S. 293, 313 (1963).

> court trier of fact has after a full hearing reliably found the facts.[90]

Then the Court set out six specific situations in which an evidentiary hearing would be mandatory under this test.

First, the district judge must hold a hearing if "the merits of the factual dispute were not resolved in the state hearing."[91] If a full and fair hearing has been made and the state trier of fact has made an express adverse determination of the facts, there is no obligation on the part of the district judge to hold an evidentiary hearing. Further, even if there has been no express finding of fact, the district judge does not have to hold an evidentiary hearing if he can ascertain that the facts have been impliedly resolved against the applicant for habeas. But, if no express finding of fact was made and if it is unclear whether the correct constitutional standards have been applied either because the applicant is able to introduce some evidence creating this doubt or because the issue of law raised by any possible interpretation of the facts presents a difficult or novel constitutional question, the district judge must hold an evidentiary hearing.

Second, the district judge must hold a hearing if "the state factual determination is not fairly supported by the record as a whole."[92] The Court makes it clear that this situation presents nothing which has not been consistently followed in the past.[93]

Third, the district judge must hold a hearing if "the fact finding procedure employed by the state court was not adequate to afford a full and fair hearing."[94] Thus, the obligation of the federal district judge does not terminate with a finding that all of the relevant facts have been presented at the state court hearing. If the state procedure is inadequate for ascertaining the truth, then the federal district judge must disregard the state findings and hold an evidentiary hearing.

Fourth, the federal district judge must hold an evidentiary hearing "where newly discovered evidence is alleged in a habeas application, evidence which could not reasonably have been presented

[90] *Id.* at 312.
[91] *Id.* at 313.
[92] *Ibid.*
[93] *Id.* at 316. See Blackman v. Alabama, 361 U.S. 199 (1960); Fiske v. Kansas, 274 U.S. 380 (1927).
[94] 372 U.S. at 313.

to the state trier of facts."[95] This evidence must relate to the constitutionality of the detention of the prisoner, as newly discovered evidence relevant to the guilt of the applicant is not a grounds for habeas relief.

Fifth, there must be a hearing if "the material facts were not adequately developed at the state court hearing."[96] This requires a hearing if for some reason not attributable to the inexcusable neglect of petitioner, evidence necessary to an adequate consideration of the constitutional claim of the petitioner was not developed at the state court hearing.

Finally, a hearing is required in the federal courts if "for any reason it appears that the state trier of fact did not afford the habeas applicant a full and fair fact hearing."[97] This category was intentionally left open because the Court thought it impossible to anticipate all of the situations in which a hearing was required.[98]

As the dissenting opinion pointed out,[99] the Court here attempted to catalogue a set of standards in advance, and this in itself is of doubtful wisdom. The policy of rendering advisory opinions has long been held to be objectionable on grounds that the Court may not give full consideration to issues not presented by the facts of the particular case before it.[100]

Furthermore, there are objections to the standards themselves. For example, the third criterion laid down by the Court requires a hearing if the state fact finding procedure is not adequate for ascertaining the truth. The Court gives the "burden of proof" as an example of something which would make the state procedure inadequate.[101] This seems to fail as a means of defining the general lan-

[95] *Ibid.*
[96] *Ibid.*
[97] *Ibid.*
[98] *Id.* at 317.
[99] *Id.* at 327.
[100] "It is a maxim, not to be disregarded, that general expressions, in every opinion, are to be taken in connection with the case in which those expressions are used. If they go beyond the case, they may be respected, but ought not to control the judgment in a subsequent suit, when the very point is presented for decision. The reason of this maxim is obvious. The question actually presented before the court is investigated with care, and considered in its full extent. Other principles which may serve to illustrate it are considered in relation to the case decided, but their possible bearing on all other cases is seldom completely investigated." Cohens v. Virginia, 19 U.S. (6 Wheat.) 264, 399-400 (1821).
[101] 372 U.S. at 316.

guage used in the formulation of this criterion, for the term "burden of proof" is itself subject to more than one meaning.[102] Other than the burden of proof, there is no hint as to what will make a state court proceeding inadequate for ascertaining the truth, and it is hard to believe that the Court really meant to leave it up to the individual judge's development of the conception of inadequacy, when the very purpose of the criterion is uniformity. The requirement seems to suffer the same fallacy found by the Court to be inherent in the *Brown* test,[103] this being that the language of the Court lends itself to varied and confused interpretations.

The fourth and fifth criteria should be read together. The fourth deals with newly discovered evidence, and the fifth covers relevant evidence which was not presented to the state court in a manner that would normally reveal its significance. Both of these reflect the principle that protection of the rights of the applicant for habeas corpus is the court's concern even above rules designed to facilitate finality of litigation. Thus, the Illinois court in the principal case had not given the petitioner a "full and fair"[104] hearing because it had not considered the effect of the drugs administered to him in the light of the material fact that the drug which had been used was commonly thought of as a truth serum. Rules as to newly discovered evidence are found in many states[105] with a difference in emphasis. As the Court views it, an evidentiary hearing should be held under the enumerated circumstances unless the federal district court judge finds that the failure to introduce or develop such evidence was due to the fault of the petitioner, whereas states have generally imposed procedural requirements having nothing to do with the fault of the convicted person.[106]

---

[102] Strohfeld v. Cox, 325 Mo. 901, 30 S.W.2d 462 (1930). "The term 'burden of proof' has two distinct meanings. By the one is meant the duty of establishing the truth of a given proposition or issue by such a quantum of evidence as the law demands in the case in which the issue arises; by the other is meant the duty of producing evidence at the beginning or at any subsequent stage of the trial, in order to make out a prima facie case." *Id.* at 907, 30 S.W.2d at 465.

[103] See text accompanying note 87 *supra.*

[104] This criterion seems to be in step with the intent of the general test to provide a full and fair hearing, as a full and fair hearing contemplates consideration of all relevant evidence, whether it was brought to the attention of the state trier of fact or not. See text accompanying note 90 *supra.*

[105] *E.g.*, R.I. GEN. LAWS ANN. ch. 23, § 9-23-2 (1956); 12 VT. STAT. § 2356 (1958).

[106] For example, 12 VT. STAT. § 2356 (1958) provides, in part: "[I]f the

When evaluating the test laid down in *Townsend,* one is apt to confuse two different questions. The first of these is whether the protection of the constitutional rights of an accused is important enough to justify both extensive examination of state practices and the confusion which must result when the same question is open to reexamination by so many different courts and procedures. As to this question, it clearly seems that *Townsend* answers in the affirmative, with only the following language of the Court possibly serving as a qualification:

> We are aware that the too-promiscuous grant of evidentiary hearings could both swamp the dockets of the district courts and cause acute and unnecessary friction with state organs of criminal justice, while the too-limited use of such hearings would allow many grave constitutional errors to go forever unprotected. The accommodation of these competing factors must be made on the front line, by the district judges who are conscious of their paramount responsibility in this area.[107]

The second question is whether or not the guidelines formulated by the Court will be sufficient to enable the federal district courts to protect an accused's constitutional rights. General objections to such tests because they resemble advisory opinions have already been discussed;[108] however, it must be remembered that the Supreme Court undertakes to exercise a supervisory power over lower federal courts,[109] and, for this reason, attempts to lay down standards may be desirable if the standards are clear and understandable. Furthermore, their existence tends to solve the problem created when lower federal courts are given broad discretionary powers to examine the practices of state appellate courts,[110] because the district judges can say with justification that they are acting under a mandate from the United States Supreme Court, which clearly has the right to review

reasons assigned are the discovery of new evidence or other matter of fact, such citation shall be served within two years after rendition of the original judgment."

[107] 372 U.S. at 319.

[108] See note 100 *supra* and accompanying text.

[109] "Judicial supervision of the administration of criminal justice in the federal courts implies the duty of maintaining and establishing civilized standards of procedure and evidence. McNabb v. United States, 318 U.S. 332, 340 (1942).

[110] See Bartor, *Finality in Criminal Law and Federal Habeas Corpus for State Prisoners,* 76 HARV. L. REV. 441 (1962).

state appellate courts in matters involving the Constitution of the United States.[111]

Another consideration which must have influenced the Court in laying down a new test was that the one formulated in *Brown v. Allen* had wrought confusing and conflicting views in the several circuits. For example, one view was that a hearing was required if the well pleaded facts were sufficient to establish a prima facie case of merit.[112] Another view had it that the trial court's determination of the disputed facts was binding on the district judge.[113] Consequently, the situation demanded clarification, and the Court may well have thought that the validity of a person's imprisonment was too important a consideration to wait on a case by case examination of each view.

However, whether the guidelines formulated in *Townsend* will provide a workable standard is an unanswerable question at the present time. The Court expressly left room to expand the situations in which an evidentiary hearing will be required,[114] and it seems to have been deliberately general in laying out those situations which it did discuss. In fact, it is probable that the Court thinks that district court judges have been too slow in granting evidentiary hearings and wrote its opinion more to change their basic approach than to revolutionize the grounds for granting evidentiary hearings. Thus, the desirability of what the Court did will be an open question to those who are not opposed to the Court's concept of habeas corpus altogether, and they will have to reserve judgment pending application of the criteria by the lower federal courts. At the present time, however, it is clear that federal district court judges have been told that protecting the constitutional rights of habeas corpus applicants is more important than considerations of the possible impact of their decisions on federal-state relations and of reducing a crowded federal docket. Therefore, habeas corpus is bound to be an increasingly important part of the process by which a criminal suspect's constitutional rights are protected.

---

[111] See 28 U.S.C § 1257 (1958).

[112] Wiggins v. Ragen, 238 F.2d 309 (7th Cir. 1956).

[113] This was view taken by the court of appeals in the principle case. See note 82 *supra* and accompanying text. See generally Comment, *Federal Habeas Corpus Review of State Convictions: An Interplay of Appellate and District Court Discretion*, 68 YALE L.J. 98 (1958).

[114] See note 98 *supra* and accompanying text.

III. SANDERS V. UNITED STATES*

In *Sanders v. United States*[115] the Supreme Court broadened post-conviction collateral relief from criminal convictions in the federal courts. Sanders was convicted of robbing a federally-insured bank and received a fifteen year sentence. Thereafter he filed a motion to vacate the conviction under 28 U.S.C. section 2255,[116] which was denied without a hearing on the ground that it alleged only bare conclusions. The court went on to say, however, that the records of the trial conclusively showed the petitioner's claims to be without merit. Subsequently, Sanders filed a second motion to vacate, alleging that he was a known narcotics addict; that medical authorities administered narcotics to him from time to time while he was being detained, including the period during which he had appeared in court; and that as a result of the administration of narcotics, he had been mentally incompetent when he had pleaded guilty and had been sentenced. The district court again denied petitioner's motion without a hearing, basing its denial on his failure to indicate why the allegation of mental incompetency had not been presented on the first motion and stating that his claims were without merit. The Court of Appeals for the Ninth Circuit affirmed the district court's decision,[117] approving the grounds on which the hearing was denied and stressing the fact that petitioner had knowledge of the facts alleged on the second motion at the time he had filed his first motion.[118] The Supreme Court of the United States granted certiorari,[119] reversed both lower courts, and held that the district court should have held a hearing on the merits of the second motion.[120]

---

* This portion of the *Note* was contributed by Richard Dailey.

[115] 373 U.S. 1 (1963).

[116] "Under that statute, a federal prisoner who claims that his sentence was imposed in violation of the Constitution or laws of the United States may seek relief from the sentence by filing a motion in the sentencing court stating the facts supporting his claim. '[A] prompt hearing' on the motion is required 'unless the motion and files and records of the case conclusively show that the prisoner is entitled to no relief....' The section further provides that 'the sentencing court shall not be required to entertain a second or successive motion for similar relief on behalf of the same prisoner.'" Sanders v. United States, 373 U.S. 1, 3-4 (1963).

[117] Sanders v. United States, 297 F.2d 735 (9th Cir. 1961).

[118] This statement of facts is taken from Sanders v. United States, 297 F.2d 735, 736 (9th Cir. 1961).

[119] 370 U.S. 936 (1962).

[120] Sanders v. United States, 373 U.S. 1 (1963).

In reaching its decision the Court was faced with the problem of interpreting the provision in section 2255 which provides that the "sentencing court shall not be required to entertain a second or successive motion for similar relief on behalf of the same prisoner."[121] At the time of this appeal this provision had received conflicting interpretations in the various circuits. Some courts had been liberal in requiring a hearing on the second motion, holding that such a motion alleging new grounds requires a hearing unless the record conclusively shows that the movant is entitled to no relief;[122] that it need only allege facts sufficient to entitle the petitioner to relief and need not allege non-abuse of the process;[123] and that a hearing is required when the government neither denies the new allegations nor pleads abuse of the process.[124] Others had been very strict, holding that even when new grounds are alleged, the court may exercise its discretion and deny a hearing on the motion.[125]

In the instant case it appears that the district court would have required without qualification that the second motion justify the omission from the first motion of the new grounds, while the court of appeals would have required such justification if it appeared that the petitioner had withheld grounds on the first motion and sought to avail himself of those grounds on a later motion.

To resolve this conflict, the Supreme Court turned to the histories of sections 2244 and 2255 of the Judicial Code. Section 2244,[126] enacted in 1948, is a codification of the following principle laid down in *Salinger vs. Loisel:*[127]

---

[121] 28 U.S.C. § 2255 (1958).

[122] Juelich v. United States, 300 F.2d 381 (5th Cir. 1962).

[123] Smith v. United States, 270 F.2d 921 (D.C. Cir. 1959). This position recognizes that the applications are frequently drafted by the petitioner without aid of counsel, and in such a case the petitioner should not be held to the niceties of pleading an elaborate negative.

[124] Dunn v. United States, 234 F.2d 219 (6th Cir. 1956).

[125] Lipscomb v. United States, 226 F.2d 812 (8th Cir. 1955); Johnson v. United States, 213 F.2d 492 (5th Cir. 1954).

[126] 28 U.S.C. § 2244 (1958) provides that "No circuit or district judge shall be required to entertain an application for a writ of habeas corpus to inquire into the detention of a person pursuant to a judgment of a court of the United States, or of any State, if it appears that the legality of such detention has been determined by a judge or court of the United States on a prior application for a writ of habeas corpus and the petition presents no new ground not theretofore presented and determined, and the judge or court is satisfied that the ends of justice will not be served by such inquiry."

[127] 265 U.S. 224 (1924).

> [E]ach application is to be disposed of in the exercise of a sound judicial discretion guided and controlled by a consideration of whatever has a rational bearing on the propriety of the discharge sought. Among the matters which may be considered, and even given controlling weight, are... a prior refusal to discharge on a like application.[128]

In *Sanders* the Court interpreted this language to mean that under section 2244 a district court may deny the second motion without a hearing only when it seeks to retry a claim fully decided in a prior motion.

Section 2255 was enacted in 1948 to provide "an expeditious remedy for correcting erroneous sentences without resort to habeas corpus,"[129] and to afford the prisoner "the same rights in another and more convenient forum."[130] Hence the similar relief provision of section 2255 should be interpreted as the equivalent of section 2244.

Thus the Court has completely removed *res judicata* as an important consideration in post-conviction collateral relief. This was done because "conventional notions of finality of litigation have no place where life or liberty is at stake and infringement of constitutional rights is alleged."[131]

In *Sanders,* as in *Fay v. Noia*[132] and *Townsend v. Sain,*[133] the Supreme Court formulated some basic rules to guide the lower federal courts. The rules announced in the *Sanders* case are intended to aid the lower courts in handling successive applications for federal habeas corpus and motions under section 2255. When a subsequent motion relies on a ground presented in the prior motion, the subsequent motion is properly denied without a hearing only if (1) the same ground was determined adversely to the applicant on the prior motion;[134] (2) the prior determination was on the merits;[135]

---

[128] *Id.* at 231.

[129] 28 U.S.C. § 2255 (1958), Reviser's Note.

[130] United States v. Hayman, 342 U.S. 205, 219 (1952).

[131] Sanders v. United States, 373 U.S. 1, 8 (1963).

[132] 372 U.S. 391 (1963). See Part I *supra.*

[133] 372 U.S. 293 (1963). See Part II *supra.*

[134] The Court defined "ground" as a sufficient legal basis for granting relief. It is necessary to distinguish between a new ground and a same ground couched in different language or supported by different legal arguments and factual allegations. Should there be any doubt as to whether two grounds are different or are the same, the court should resolve the doubt in favor of the petitioner. 373 U.S. at 16.

[135] "[I]f factual issues were raised in the prior application, and it was not

and (3) the ends of justice would not be served by a hearing on the merits of the subsequent motion.[136] In a case where a subsequent application presents either a new ground or a ground previously alleged but not adjudged on the merits, a hearing on the merits of the subsequent application must be held unless there has been an abuse of process on the part of the petitioner and the Government has the burden of pleading such abuse.[137] Thus it is clear that there are two principles upon which a subsequent motion may be denied without a hearing: a prior adverse determination of the grounds on the merits and abuse of process. The Court addressed these principles to the sound discretion of the federal trial judges. "Theirs is the major responsibility for the just and sound administration of the federal collateral remedies, and theirs must be the judgment as to whether a second or successive application shall be denied without consideration of the merits."[138]

These three cases reflect the Court's concern with making available to prisoners an effective device to safeguard their constitutional rights. Quoting in part from *Fay,* the Court in *Sanders* said: "If 'government . . . [is] always [to] be accountable to the judiciary for a man's imprisonment' . . . access to the courts on habeas must not be thus impeded."[139]

The Supreme Court, in these decisions, seems to be eliminating the authority of a lower federal court to deny a hearing on a motion for collateral relief on procedural defects alone. It appears now that

---

denied on the basis that the files and records conclusively resolved these issues, an evidentiary hearing was held." 373 U.S. at 16.

[136] Even when a prior motion has been denied on the merits, the court may, in its discretion, consider a subsequent motion. The petitioner may, for example, show that there has been an intervening change in the law; or he may show that he did not receive a full and fair evidentiary hearing on the prior motion. (The criteria of a full and fair evidentiary hearing are discussed in *Townsend v. Sain*). The burden is on the petitioner to show that the ends of justice would be served by a redetermination of a ground previously adjudged adversely to him. 373 U.S. at 16-17.

[137] The Court does not allocate the burden of proof; however, in Price v. Johnston, 334 U.S. 266 (1948), the Court placed the burden on the petitioner to prove non-abuse of the writ of habeas corpus. This is a justifiable allocation of the burden; the relevant facts would nearly always be within the exclusive possession of the petitioner. Furthermore, a prisoner who wishes to reopen his case and challenge the finality of the litigation should be required to show that he is acting in good faith and not out of a desire to harass the courts.

[138] 373 U.S. at 18.

[139] 373 U.S. at 8.

the court must hear any motion for relief unless the record conclusively shows the movant is not entitled to a hearing or unless it is evident that the movant has abused the process. Determining whether or not an applicant has a just complaint is thus more important than requiring him to conform to the niceties of judicial procedure.

IV. Conclusion

Though the general and sweeping language of the Court in these three decisions makes it difficult to formulate concrete predictions about the outcome of future cases, it seems fairly certain, barring action by Congress or a change in the personnel of the Court, that habeas corpus will be an important instrument in determining the scope of the ever-increasing constitutional protection afforded those accused of crime. The remaining obstacle which the court faces, however, is formidable. From 1946 to 1957 only 1.4 per cent of the applicants for habeas corpus were successful.[140] This may be because most of the applications were "frivolous,"[141] or it may be because federal district judges have neither been disposed nor equipped to determine whether habeas corpus should have been granted. Yet the number of such applications has been steadily increasing,[142] and these decisions, when coupled with those in *Gideon v. Wainright*[143] and *Mapp v. Ohio*,[144] are bound to cause an even greater augmentation.

In the light of problems of time and personnel which are certain to plague the lower federal courts, the Supreme Court has only three alternatives. It can continue to reverse the decisions of the lower federal courts and thus complicate the problems even more; it can devise either some methods to aid these courts in determining whether there is merit in an application, rather than just the possibility of merit, or some rules facilitating finality of litigation; or it can retreat from the position it has taken in these three cases. Of these only the second is desirable. The constitutional rights of the criminally accused are indeed important, but unless there is a way

[140] Fay v. Noia, 372 U.S. 391, 445 n.1 (1963) (dissenting opinion).
[141] This is Mr. Justice Clark's reason. *Id.* at 445.
[142] *Id.* at 446 n.2.
[143] 372 U.S. 335 (1963).
[144] 367 U.S. 643 (1961).

to make hearing their applications physically possible, these constitutional rights will not be adequately protected by the writ of habeas corpus.

ROBERT BAYNES
RICHARD DAILEY
DEWITT MCCOTTER

Federal Income Taxation—The Unhappy Circumstance of Liquidation And Reincorporation

Two recent decisions of the Tax Court, *David T. Grubbs*[1] and *Joseph C. Gallagher*,[2] illustrate the problems which confront the Commissioner of Internal Revenue when he attempts to tax distributions of accumulated earnings and profits[3] at ordinary income tax rates when such distributions occur in a transaction of preincorporation-liquidation or liquidation-reincorporation.

In a typical situation the corporation will have been in business for some time and have accumulated at least a material amount of earnings and profits. Assume that a new corporate entity is formed and that the essential operating assets of the old corporation are transferred to the new corporation for voting stock. The shareholders then liquidate the old corporation and distribute the new corporation's stock and any remaining cash and other liquid assets to the stockholders of the old corporation (preincorporation-liquidation).[4]

If the device is successful there will be a complete liquidation

[1] 39 T.C. No. 5 (Oct. 8, 1962).

[2] 39 T.C. No. 13 (Oct. 17, 1962). An appeal to the Ninth Circuit was dismissed.

[3] This term (earnings and profits) is not defined in the 1954 Code; however, § 312 describes the effect some transactions have on earnings and profits. For purposes of this note, earnings and profits can be thought of as the retained earnings or earned surplus of the corporation, without regard to the fact that some transactions may be recorded differently for federal tax purposes than for corporate book purposes. See generally STANLEY & KILCULLEN, THE FEDERAL INCOME TAX § 301 at 119 (4th ed. 1961); WIXON, ACCOUNTANTS' HANDBOOK § 22 (4th ed. 1960).

[4] A similar problem is raised when the old corporation is liquidated, distributing its cash, liquid and operating assets to its shareholders, part or all of whom then reincorporate the operating assets and continue the business in corporate form (liquidation-reincorporation). See generally Kuhn, *Liquidation and Reincorporation Under the 1954 Code*, 51 GEO. L.J. 96 (1962); Rice, *When is a Liquidation Not a Liquidation for Federal Income Tax Purposes?*, 8 STAN. L. REV. 208 (1956).

under section 337 of the Internal Revenue Code of 1954,[5] or at least a partial liquidation under section 346,[6] with the distributees acquiring the assets at a stepped-up basis (fair market value) under section 334; and, with the stepped-up basis continuing in the new corporation under section 362(a).[7] In such a case the distributions of cash and other property would be treated as liquidating distributions under section 331,[8] therefore receiving sale or exchange treatment. The probable purpose of such a transaction is to withdraw accumulated earnings and profits from the old corporation at the lower capital gain rates and to continue to operate the same business assets in a corporate form with essentially the same ownership. The alternative method for withdrawing these accumulated earnings and profits is for the corporation to declare a dividend, with resulting taxation at ordinary income tax rates under sections 61(a), 301(c)(1), and 316(a) of the 1954 Code.[9]

---

[5] INT. REV. CODE OF 1954, § 337, provides "(a).... If—

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims,

then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period." See generally Rice, *Problems in Section 337 Liquidations,* N.Y.U. 20TH INST. ON FED. TAX 939 (1962); Note, 76 HARV. L. REV. 780 (1963).

[6] INT. REV. CODE OF 1954, § 346, provides "(a).... For purposes of this subchapter, a distribution shall be treated as in partial liquidation of a corporation if—

(1) the distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan; or

(2) the distribution is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan, and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year...."

See generally Bittker, *Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954,* 9 STAN. L. REV. 13 (1956).

[7] INT. REV. CODE OF 1954, § 334, states that "(a).... If property is received in a distribution in partial or complete liquidation . . . , and if gain or loss is recognized on receipt of such property, then the basis of the property in the hands of the distributee shall be the fair market value of such property at the time of the distribution." And in INT. REV. CODE OF 1954, § 362(a), it is provided that "if property was acquired... by a corporation—

(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, or

(2) as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer."

[8] INT. REV. CODE OF 1954, § 331, provides "(a). . . .

In *Grubbs* the approach of the Commissioner and decision in the case adhere to case law principles developed or established under the 1939 Code.[10] There, *G* and *B* along with fourteen other shareholders owned the selling corporation. In accordance with a plan of reorgani-

---

(1) .... Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock.

(2) .... Amounts distributed in partial liquidation of a corporation ... shall be treated as in part or full payment in exchange for the stock.

(b) .... Section 301 (relating to effects on shareholder of distributions of property) shall not apply to any distribution of property in partial or complete liquidation." This rule originated in Hellmich v. Hellman, 276 U.S. 233 (1928).

[9] "The opportunities for minimizing taxes illustrated [by such a transaction] . . . presumably arise from a policy determination by Congress that when a corporate enterprise is ended and the participants go their separate ways, the gains from the enterprise should be taxed on a capital gain basis and the slate wiped clean with respect to future use of the assets. It would seem reasonable to assume, however, that Congress intended this result only in cases where the enterprise was terminated in some substantial sense; that it did not intend to permit stockholders to have tax advantages in cases where their interests still remained 'in solution' in an enterprise which supplanted the one which had been liquidated. The problem faced by the courts in this area . . . is . . . one of drawing a line." Rice, *When Is a Liquidation Not a Liquidation for Federal Income Tax Purposes?*, 8 STAN. L. REV. 208, 210-11 (1956). See generally Schwartz, *Reincorporations Under the 1954 Code*, 15 U. FLA. L. REV. 159 (1962).

[10] The traditional approach of the Commissioner prior to the enactment of the 1954 Code was to assert that there had been a reorganization under § 112(g)(1)(D) of the 1939 Code, 53 Stat. 40, quoted in part note 18 *infra* (now INT. REV. CODE OF 1954, § 368(a)(1)(D)). When he won, the Commissioner succeeded in forcing the new corporation to take the transferred property at the same basis it had in the hands of the old corporation; and, in addition the Commissioner was able to tax "boot" distributions to the extent of accumulated earnings and profits at ordinary income tax rates under § 112(c) of the 1939 Code, 53 Stat. 39 (now INT. REV. CODE OF 1954, § 356). See Commissioner v. Morgan, 288 F.2d 676 (3d Cir.), *cert. denied*, 368 U.S. 836 (1961); Lewis v. Commissioner, 176 F.2d 646 (1st Cir. 1949); Heller v. Commissioner, 147 F.2d 376 (9th Cir. 1945), *affirming* 2 T.C. 371 (1943), *cert denied*, 325 U.S. 868 (1945); Ethel K. Lesser, 26 T.C. 306 (1956); James G. Murrin, 24 T.C. 502 (1955); Pebble Springs Distilling Co., 23 T.C. 196 (1954), *aff'd*, 231 F.2d 288 (7th Cir.), *cert. denied*, 352 U.S. 836 (1956); William M. Liddon, 22 T.C. 1220 (1954), *aff'd on this issue*, 230 F.2d 304 (6th Cir.), *cert. denied*, 352 U.S. 824 (1956); Richard H. Survaunt, 5 T.C. 665 (1945), *aff'd*, 162 F.2d 753 (8th Cir. 1947).

However, the Commissioner did not always win on the "reorganization" theory. See United States v. Arcade Co., 203 F.2d 230 (6th Cir.), *cert. denied*, 346 U.S. 828 (1953); Braicks v. Henricksen, 43 F. Supp. 254 (W.D. Wash. 1942), *aff'd*, 137 F.2d 632 (9th Cir. 1943); Austin Transit, Inc., 20 T.C. 849 (1953).

See generally 3 MERTENS, FEDERAL INCOME TAXATION § 20.92 (rev. ed. 1957).

[11] The plan of reorganization is a requirement of INT. REV. CODE OF 1954, § 354(a)(1). See generally MERTENS, CODE COMMENTARY, FEDERAL

zation[11] "assets . . . were transferred to . . . [Buyer] and the stock in . . . [Seller] was surrendered and the stockholders received cash and acquired stock in [Buyer]. . . ."[12] All stock of Seller was redeemed by it except 350 shares held by *B*. The transaction thus left *G* and the other fourteen shareholders of Seller holding pro rata shares in the new corporation plus cash distributions made by the old corporation in connection with the redemption of its stock.[13] *B*, however, remained as sole owner of the corporate shell of the selling corporation.[14]

On these facts the Commissioner asserted that the several transactions which accompanied the transfer of the old corporation's business to the new corporation "amount to a reorganization under which the stockholders of the old corporation exchanged their stock for stock in the new corporation and cash and that the exchange had the effect of the distribution of a dividend."[15]

The Tax Court sustained the Commissioner's position, finding a reorganization under section 368(a)(1)(D)[16] by applying the

---

INCOME TAXATION § 354(a)(1):3 (1955); 3 MERTENS, FEDERAL INCOME TAXATION § 20.95 (rev. ed. 1957); Manning, *"In Pursuance of the Plan of Reorganization": The Scope of the Reorganization Provisions of the Internal Revenue Code*, 72 HARV. L. REV. 881 (1959).

[12] 39 T.C. No. 5 at 7.

[13] The new corporation was authorized to issue 1,000 shares of Class A common stock and twice that amount of Class B common stock. Each with equal voting rights. In addition to the transfer of assets from the old corporation to the Buyer, which was for 750 shares of Class B common, *B* received an additional 150 shares of Class A common in exchange for the assets and liabilities of a sole proprietorship he had been operating since 1956. 39 T.C. No. 5 at 3, 5.

[14] There was, therefore, no actual distribution by Seller to *B*. He merely remained as the sole owner of the corporation through which he planned thereafter to conduct a finance business. The old corporation had been engaged primarily in the automobile dealership business, and had not made any loans. The finance business was, therefore, a new business for Seller. 39 T.C. No. 5 at 10.

[15] 39 T.C. No. 5 at 8.

[16] "(a) . . . .

(1) . . . the term 'reorganization' means . . . ,

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354 . . . or 356." INT. REV. CODE OF 1954, § 368(a)(1)(D).

step-transaction theory.[17] This section provides that a "D" reor-

[17] Taxpayer's "contention would treat the redemption of the stock of the old corporation as an isolated transaction. But when the same stockholders continue to carry on the same business in corporate form through another corporation, the several steps may not be so isolated. The consequences of the rearrangement must be judged by the total effect. Where a redemption of stock is one of a series of steps in a reorganization, the tax treatment is governed by the provisions of law relating to reorganizations." 39 T.C. No. 5 at 9. Under the step-transaction theory the court considers the liquidation as a step in the reorganization. This allows application of the reorganization provisions to a liquidation-reincorporation transaction. The theory developed prior to the 1954 Code, and was used by the Commissioner in efforts to tax the liquidation-reincorporation, at least to some extent, at ordinary income tax rates. See note 10 *supra* and cases cited therein. In Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945), the Court stated that "the incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant." Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942), is an oft cited case in this area. There the Court admonished that there could be no segregation of steps when they were all taken as integrated parts of a single scheme; and in Southwell Combing Co., 30 T.C. 487, 497-98 (1958), the court said "it is well settled that where a transaction is comprised of a series of interdependent steps, that is to say, where the legal relationships created by any one step would have been fruitless without the completion of the entire series, the various steps are to be integrated into one for the purpose of arriving at the tax consequences of the transaction. . . . [I]t is the situation at the beginning and the end of the series which determines whether there has been a statutory reorganization or merely a taxable exchange." See Helvering v. Le Gierse, 312 U.S. 531 (1941); Minnesota Tea Co. v. Helvering, 302 U.S. 609 (1938); Bausch & Lomb Optical Co. v. Commissioner, 267 F.2d 75 (2d Cir.), *cert. denied,* 361 U.S. 835 (1959); Bard-Parker Co. v. Commissioner, 218 F.2d 52 (2d Cir. 1954), *cert. denied,* 349 U.S. 906 (1955); Fisher v. Commissioner, 108 F.2d 707 (6th Cir. 1939); Ahles Realty Co. v. Commissioner, 71 F.2d 150 (2d Cir. 1934); William M. Liddon, 22 T.C. 1220 (1954), *reversed on other grounds,* 230 F.2d 304 (6th Cir.), *cert. denied,* 352 U.S. 824 (1956); Richard H. Survaunt, 5 T.C. 665 (1945), *aff'd,* 162 F.2d 753 (8th Cir. 1947).

The step-transaction doctrine, however, has not had universal application. See United States v. Arcade Co., 203 F.2d 230 (6th Cir.), *cert. denied,* 346 U.S. 828 (1953), where the assets of the dissolved corporation went through trustees at the direction of the old stockholders, with the trustees then receiving stock in a new corporation. The stock was distributed to the old shareholders as beneficiaries of the trust. The circuit court held that there was not a reorganization because there was not a corporation-to-corporation transfer of the assets. The court here refused to adopt the theory of Fisher v. Commissioner, 108 F.2d 707 (6th Cir. 1939). In *Fisher* the passage of the assets through intervening hands did not prevent the court from finding a reorganization, holding the intervenors to be merely "conduits." In agreement with the *Arcade Co.* case is Braicks v. Henricksen, 43 F. Supp. 254 (W.D. Wash. 1942), *aff'd,* 137 F.2d 632 (9th Cir. 1943).

See generally PAUL & ZIMET, SELECTED STUDIES IN FEDERAL TAXATION 200-54 (2d Series 1938); Mintz & Plumb, *Step Transactions in Corporate*

ganization takes place "only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354 . . . or 356."[18] Under section 354[19] the selling or transferring corporation is required to transfer "substantially all"[20] of its assets to the buying

Reorganizations, N.Y.U. 12TH INST. ON FED. TAX 247 (1954); Rice, *Judicial Techniques In Combating Tax Avoidance,* 51 MICH. L. REV. 1021, 1046 (1953).

[18] INT. REV. CODE OF 1954, § 368(a)(1)(D). This requirement is new in the Internal Revue Code of 1954. Section 112(g)(1)(D) of the 1939 Code, predecessor of the present section, provided "a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders are both in control of the corporation to which the assets are transferred" is a "D" reorganization. The 1954 addition serves to restrict the "D" reorganization.

[19] "(a) . . . .

(1) . . . . No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization . . . .

(b) EXCEPTION.—

(1) . . . . Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368(a)(1)(D), unless—

(A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and

(B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization." INT. REV. CODE OF 1954, § 354.

Section 354 "does not appear to apply to the divisive or corporate separation type of reorganization." MERTENS, CODE COMMENTARY, FEDERAL INCOME TAXATION § 354(b):1 (1955).

[20] Section 368(a)(1)(D) states that there must be a transfer of "all or a part of its assets to another corporation." However, this must be read in conjunction with section 354(b)(1)(A), which requires a transfer of "substantially all of the assets of the transferor . . . ." "The requirement that substantially all of the assets of the transferor go over to the transferee and that the transferor distribute all of its assets remaining, plus the stock, securities or other properties received upon the transfer to the transferee . . . appears designed to insure first that a reincorporation was substantially intended, and secondly that any money or other 'boot' assets will be taxed as such by reason of the required distribution in connection with the plan of reorganization." MERTENS, CODE COMMENTARY, FEDERAL INCOME TAXATION § 354(b):1 (1955). In The Daily Tel. Co., 34 B.T.A. 101, 105 (1936), the court stated that "the term 'substantially all' is a relative term, dependent on the facts of any given situation," and in Gross v. Commissioner, 88 F.2d 567 (5th Cir. 1937), *reversing* 34 B.T.A. 395 (1936), the court held that substantially all of the assets included properties useful in the business. This was found to mean such cash as was needful for working capital, but "substantially all" did not include surplus cash distributed to shareholders of the old corporation. See Britt v. Commissioner, 114 F.2d 10 (4th Cir. 1940); Commissioner v. First Nat'l Bank, 104 F.2d 865 (3d Cir. 1939); Schuh Trading Co. v.

or transferee corporation. The section, in addition, provides that "no gain or loss shall be recognized if stock... [is] exchanged solely for stock"[21] of another corporation in pursuance of a plan of reorganization. Under section 356,[22] when other property or money is received in addition to stock on such an exchange, the gain is to be recognized in an amount not in excess of the value of the property received. Section 356 also provides that when a distribution in such an exchange has the effect of a dividend, such gain is to be treated as a dividend to the extent that accumulated earnings and profits are distributed.[23]

Thus, in *Grubbs, B* and *G* had voting control[24] of both transferor

---

Commissioner, 95 F.2d 404 (7th Cir. 1938); Pillar Rock Packing Co. v. Commissioner, 90 F.2d 949 (9th Cir. 1937); Western Indus. Co. v. Helvering, 82 F.2d 461 (D.C. Cir. 1936); Wellington Fund, Inc., 4 T.C. 185 (1944); Milton Smith, 34 B.T.A. 702 (1936); Alice V. St. Onge, 31 B.T.A. 295 (1934); Arctic Ice Mach. Co., 23 B.T.A. 1223 (1931).

"The fact that properties retained by the transferor corporation, or received in exchange for the properties transferred in the reorganization, are used to satisfy existing liabilities not represented by securities and which were incurred in the ordinary course of business before the reorganization does not prevent the application of section 354 to an exchange pursuant to a plan of reorganization defined in section 368(a)(1)(D)." Treas. Reg. § 1.354-1(a)(2) (1955).

[21] INT. REV. CODE OF 1954, § 354(a)(1).

[22] (a) GAIN ON EXCHANGES.—

(1) RECOGNITION OF GAIN.—If—

(A) section 354... would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354... to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) TREATMENT AS DIVIDEND.—If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property." INT. REV. CODE OF 1954, § 356.

[23] Quoted in part note 22 *supra*. See Commissioner v. Bedford, 325 U.S. 283 (1945). See generally Darrell, *The Scope of Commissioner v. Bedford Estate*, 24 TAXES 266 (1946); Horrow, *Recent Developments in Corporate Reorganizations*, U. So. CAL. 1963 TAX INST. 251, 268; Wittenstein, *Boot Distributions and Section 112(c)(2): A Reexamination*, 8 TAX L. REV. 63 (1952).

[24] INT. REV. CODE OF 1954, § 368(c), defines control as "the ownership of stock possessing at least 80 percent of the total combined voting power of all

and transferee corporations. The plan of reorganization was arranged to permit continuation of the corporate business in the new corporate cloak with "no break in the continuity of the proprietary interest."[25] The transferee corporation received all of the assets of the transferring corporation, and there was a distribution of transferee's stock in pursuance of the plan of reorganization.[26] The situa-

classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation."

[25] 39 T.C. No. 5 at 8. The doctrine of "continuity of interest" is a judicial concept which has been picked up in the regulations. Treas. Reg. 1.368-1(b) (1955), states that "requisite to a reorganization under the Code [is] ... a continuity of interest therein on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization." In Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 470 (1933), the Court stated that to be within the reorganization provisions "the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes." Thus, continuity of interest involves acquiring an interest in the affairs of the purchasing company or corporation. This doctrine is involved in the precept that mere compliance with the statutory reorganization provisions is not enough, the requirement of this judicial concept must be met. The doctrine dates back to Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir. 1932), where the court held that although there had been literal compliance with the reorganization statutes, the transfer of substantially all of its properties by a corporation for short-term promissory notes and cash was too much like a sale, and without a continuance of interest by the seller no reorganization existed. See LeTulle v. Scofield, 308 U.S. 415 (1940); Helvering v. Watts, 296 U.S. 387 (1935); Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935); John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935); Alan O. Hickok, 32 T.C. 80 (1959). It should be noted that this judicial concept is somewhat obviated because of the statutory control requirement in § 368(c) (80 per cent), quoted in part note 24 *supra*. See generally 3 MERTENS, FEDERAL INCOME TAXATION § 20.59 (rev. ed. 1957); Baker, *Continuity of Interest Requirement in Reorganizations Reexamined—The Hickok Case*, N.Y.U. 18TH INST. ON FED. TAX 761 (1960); Brookes, *The Continuity of Interest Test in Reorganizations—A Blessing or a Curse*, 34 CALIF. L. REV. 1 (1946); Griswold, *Securities and Continuity of Interest*, 58 HARV. L. REV. 705 (1945).

[26] The language of § 354(b)(1)(B), quoted in part note 19 *supra*, implies that there should be a complete liquidation before the transaction can qualify under section 354, as required by section 368(a)(1)(D) for a statutory reorganization. We do not quite have that situation in *Grubbs* since the transferor corporation received a note from transferee for the amount of *B*'s ratable share. *B* still held his stock in transferor which he planned to use in its corporate form in the financing business. The contention was made that this failure to make an actual distribution to *B* made the distributions substantially disproportionate within § 302(b)(2) as regards the shareholders. If such a contention were sustained the distributions would qualify as "exchanges"; however, the court found that since *B* was the sole stockholder remaining in transferor, and that since the corporation had received his pro rata share of the distribution, they (the court) had no control over what form *B* chose to take his distribution in, and that actually he had received his pro rata share of the distributions. Thus, there was no dispro-

tion in *Grubbs* squarely meets the requirements for a statutory "D" reorganization. Accordingly the Commissioner successfully asserted that the corporation-to-corporation transfer was tax-free with the result that no stepped-up basis was obtained for the operating assets transferred, and that the distributions of additional compensation or "boot" were taxable as in the nature of an ordinary dividend to the extent that they came out of accumulated earnings and profits, under the provisions of section 356.[27]

In *Gallagher*[28] the facts present a basically similar problem; however, the main contention of the Commissioner and the result in the case are different from those in *Grubbs*. In *Gallagher* the old corporation had been incorporated in Delaware in 1946, and from that time until its dissolution in 1955 it had been engaged in the general stevedoring and terminal business in certain ports on the west coast. It had in excess of 900,000 dollars in accumulated earnings and profits. The Delaware corporation owned the equipment used in the business but no real estate. The shareholders of the corporation were divided into two distinct groups: (1) the active shareholders (officers and directors), who owned approximately 62 per cent of the outstanding stock, and (2) the inactive shareholders (estates and widows), who held the remaining 38 per cent.

During 1955 the active shareholders formed a new corporation under the laws of California with the same name as that of the old Delaware corporation. The active shareholders received 72 and ⅔ per cent of the new corporation's stock, with the remaining 27 and ⅓ per cent being issued to employees of the old corporation who were considered "key" and who, prior to this time, had had no equity ownership in the business. The shareholders paid 300,000 dollars in cash for the new corporation's stock. The old corporation, in accordance with a plan of complete liquidation, thereupon sold its operating assets to the new corporation for cash. The old corporation was then liquidated, with a subsequent distribution of its assets including the cash received from the new corporation as proceeds from the sale. The taxpayers "treated the liquidating distributions . . . as part or full payment in exchange for their stock and reported the

portionate distribution. This "piercing of the corporate veil" seems justified and does no harm to the statute.

[27] Quoted in part note 22 *supra*; see also authorities cited note 23 *supra*.

[28] Joseph C. Gallagher, 39 T.C. No. 13 (Oct. 17, 1962).

amounts received in excess of the adjusted basis as long-term capital gains."[29]

The Commissioner asserted a deficiency, insisting that the distributions "received... [are] taxable in full as dividend income."[30] The Commissioner based his contention on two alternative arguments: (1) that, in substance, a partial or complete liquidation did not occur and that therefore amounts "received by the individual consisted of a dividend within the purview of section 301...",[31] or (2) that there was a statutory "reorganization within the meaning of section 368...,"[32] in which case the cash distributions would be treated as "boot" under section 356 and taxed as ordinary income to the extent attributable to accumulated earnings and profits. The court, however, found that a partial liquidation had in fact occurred. Thus the court respects the liquidation of the old corporation and the distributions in question receive sale or exchange treatment.

The court felt that, although the Commissioner did "not specifically refer to section 302, the implication appears to be that the redemption... was essentially equivalent to a dividend under section 302(b)(1)"[33] and was thus "not to be treated as a capital transaction under section 302(a), but as a dividend under section 301(c)-(1), with ordinary income consequences."[34] The court stated that "there can be no doubt that the stock... was redeemed."[35] However, "the redemption was only one step in what was undoubtedly a

---

[29] *Id.* at 11.

[30] *Ibid.*

[31] *Id.* at 11-12. INT. REV. CODE OF 1954, § 301, provides, *inter alia,* for the inclusion in gross income a distribution by a corporation which is a "dividend."

[32] *Id.* at 12. It is interesting to note that apparently the Commissioner did not specify which type of reorganization he meant.

[33] *Ibid.* INT. REV. CODE OF 1954, § 302 provides "(a).... If a corporation redeems its stock..., and if paragraph (1), (2), (3)... of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) ....

(1).... Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) ....

(A).... Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder....

(3).... Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder."

[34] 39 T.C. No. 13 at 12.

[35] *Id.* at 13.

liquidation-reincorporation operation . . . ."[36] The court thus invokes the step-transaction theory and consequently the reorganization provisions of the Code.[37] The Commissioner, however, wanted the liquidation of the old corporation ignored, with the transaction being tested solely as a redemption. But the Commissioner had not made it clear whether he supported his main contention with the rationale of *Bazley v. Commissioner*[38] and *Gregory v. Helvering*.[39]

Bazley involved a recapitalization[40] which fitted the literal requirements of the statute. However, in that case the Supreme Court held that "a 'reorganization' which is merely a vehicle, however elaborate or elegant, for conveying earnings from accumulations to the stockholders is not a reorganization under [the statute] . . . ."[41] *Bazley* was preceded by the *Gregory* case. There the Court held that the formation of a new corporation merely for the purpose of enabling stockholders to receive distributions (upon its subsequent liquidation) as liquidating instead of as ordinary dividends, and where no "business purpose"[42] was served, is not a reorganization

[36] *Ibid.* The court gives *Grubbs* as authority here.

[37] "The concept of a continuation of the existing business through a section 331 liquidation, coupled with an intercorporate transfer, falls into the general area of corporate reorganizations, so that it is in the so-called reorganization sections, if anywhere, that we should expect it to be dealt with." 39 T.C. No. 13 at 14. See note 17 *supra* and cases cited therein.

[38] 331 U.S. 737, *rehearing denied and prior opinion amended* 332 U.S. 752 (1947).

[39] 293 U.S. 465 (1935).

[40] Int. Rev. Code of 1939, ch. 1, § 112(g)(1)(E), 53 Stat. 40 (now INT. REV. CODE OF 1954, § 368(a)(1)(E)).

[41] 331 U.S. 737, 743 (1947).

[42] "Business purpose" is the second of two judicial concepts (for the first, "continuity of interest," see note 25 *supra*). The "business purpose" concept developed out of the case of Gregory v. Helvering, 293 U.S. 465 (1935), wherein the formation of a second corporation, transfer of certain securities to it, and its subsequent liquidation were found to be without business substance and entered into solely for the purpose of tax advantage for a major stockholder. In that case the Court held that although the transaction met the literal requirements of the reorganization statute, there was in reality no reorganization and the distributions of the second corporation, upon its liquidation, were ordinary dividends instead of liquidating distributions. The "business purpose" doctrine is mainly aimed at the "sham" or "merely for tax avoidance" transaction. It was further developed in Bazley v. Commissioner, 331 U.S. 737 (1947), and has been tabbed the "net effect" test, *i.e.*, what is the net effect of the transaction? See Liddon v. Commissioner, 230 F.2d 304 (6th Cir. 1956).

A refinement of this doctrine is acknowledged by Treas. Reg. § 1.368-1(b) (1955), providing that "requisite to a reorganization under the Code [is] . . . a continuity of the business enterprise under the modified corporate form . . . ." The regulation appears to be aimed at the situation where reor-

within the intent of the statute. The effect of the decision was to ignore the formation and liquidation of the second corporation and to treat the distributions as ordinary dividends.

The Commissioner desired that the court "judge not according to the appearance,"[43] but find that the liquidation of the old corporation was in substance not a liquidation "although it literally complied with all the terms, because the transaction is alleged to have been primarily a vehicle for the distribution of undistributed earnings."[44] The court stated, however, that unlike the recapitalization-reorganization "involved in *Bazley* and similar cases, liquidation is usually accompanied by some kind of distribution which may well include accumulated earnings of the liquidating corporation."[45]

The court noted that complete liquidation is not defined in the Code or the regulations, and concluded that a complete liquidation exists only when there is not a partial liquidation. Under section 346(a)(1) a distribution in partial liquidation occurs if "the distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan...."[46] Thus, the court held that the distributions made by the old corporation fell within

---

ganization treatment is sought and there is no intention to continue in business. The requirement is that there be a continuity in the business activity, not necessarily that the identical or a closely related business activity be engaged in. Bentsen v. Phinny, 199 F. Supp. 363 (S.D. Tex. 1961); Scott, *Recent Developments in the Federal Income Tax Laws—A Selective Survey of Recent Judicial Decisions,* 41 N.C.L. REV. 783, 822 (1963).

Thus, under the "business purpose" doctrine, the court must find that the transaction has a valid business purpose, and also that there is an intention to continue the business in modified corporate form, although it does not have to be the same business which was being conducted prior to the reorganization.

In *Gallagher* "the following were some of the corporate business reasons for liquidating [the transferor]...: to eliminate the inactive estates and widows...from the business; to permit Gallagher to acquire more stock so that Bush and Gallagher could control the business; to bring into stock ownership seven or eight executives who had helped in making a success of [the transferor]...; to limit Cuffe's ownership of the business." 39 T.C. No. 13 at 10. Business purpose did not really enter into the court's decision in *Gallagher,* although it recognized those listed as constituting valid business reasons for the transaction as carried out. Wolf Envelope Co., 17 T.C. 471 (1951); Marjorie N. Dean, 10 T.C. 19 (1948). The court stated that it rested "the conclusion that there was no reorganization here on the form and content of the reorganization sections, not on the ground that there was no business purpose" for the transaction. 39 T.C. No. 13 at 19.

[43] *John* 7:24 (King James).

[44] 39 T.C. No. 13 at 15.

[45] *Ibid.*

[46] INT. REV. CODE OF 1954, § 346(a)(1).

the literal provisions of section 346, even though the series of distributions completely liquidated the old corporation. The provisions of section 331(a)(2) are applicable, and provide "that amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. This carries as a natural corollary that such amounts shall not be treated as dividends."[47]

The court supported its position that the distributions should not receive ordinary dividend treatment by noting that the instant situation fell within the terms of section 346(a)(1), and that such a distribution in redemption of all the stock can never be essentially equivalent to a dividend, since Congress included in section 346(a)(2) language taxing distributions "essentially equivalent to a dividend" but omitted this language from section 346(a)(1).[48]

In finally disposing of the Commissioner's main contention the court stated:

> [W]e have been referred to no authority, either under the 1954 Code or under the less restrictive language of the preceding revenue acts, in which a liquidation-reincorporation has been held to give rise to ordinary income, except where that result could be accomplished by applying the provisions relating to reorganizations.[49]

After thus indicating that it would deal with this type of situation only under the reorganization provisions, the court summarily disposed of Commissioner's alternative contention that a reorganization had taken place. Utilizing the step-transaction theory made it possible to see this manipulation as an acquisition of the old corporation's assets by the new corporation for voting stock. However, the Commissioner did not urge that there was a "C" reorganization, presumably because there was a cash payment to the retiring stockholders (38 per cent).[50] Although liquidation-reincorporations are

[47] Fowler Hosiery Co., 36 T.C. 201, 222 (1961), *aff'd*, 301 F.2d 394 (7th Cir. 1962).

[48] Quoted in part note 6 *supra*.

[49] 39 T.C. No. 13 at 17.

[50] "(a) ....

(1) ... the term 'reorganization' means ...

(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, ..." INT. REV. CODE OF 1954, § 368(a)(1)(C). See Helvering v. Southwest Consol. Corp., 315 U.S. 194, *rehearing denied*, 315 U.S. 829, *second petition for rehearing denied*, 316 U.S. 710 (1942).

usually attacked under the type "D" reorganization provision,[51] the Commissioner renounced that provision in *Gallagher* because the shareholders of transferee who were also shareholders of the transferor did not have the requisite eighty per cent control required for such a reorganization.[52] In further dealing with Commissioner's reorganization argument, the court stated that there was not an "E" reorganization[53] because "there was not that reshuffling of a capital structure, *within the framework of an existing corporation,* contemplated by the term 'recapitalization.' "[54] "And the shift that occurred in the proprietary interest of the two corporations was hardly the '*mere* change in identity, form or place of organization' "[55] required for an "F" reorganization.[56] There being no other available possibilities under the reorganization provisions, the Commissioner was defeated by the court's literal application of the statute.

These two decisions, *Grubbs* and *Gallagher,* point out several things. First, that when a transaction involves the transfer of substantially all the assets of a corporation to a new corporation 80 per cent or more controlled by the transferor or its shareholders, and there is a liquidation of the transferring corporation with distributions of its remaining liquid assets and cash, plus stock in the new corporation, to the original corporation's shareholders, the step-transaction theory will be invoked with the court finding a reorgani-

[51] See note 10 *supra* and cases cited therein.

[52] INT. REV. CODE OF 1954, § 368(c), quoted in part note 24 *supra.*

[53] INT. REV. CODE OF 1954, § 368(a)(1)(E) (recapitalization).

[54] Joseph C. Gallagher, 39 T.C. No. 13 at 18, quoting Helvering v. Southwest Consol. Corp., 315 U.S. 194, 202 (1942). See also Stollberg Hardware Co., 46 B.T.A. 788 (1942).

[55] 39 T.C. No. 13 at 18.

[56] INT. REV. CODE OF 1954, § 368(a)(1)(F). The *Gallagher* holding as pertains to the possibility of an "E" or an "F" reorganization squarely conflicts with the position taken by the Commissioner in REV. RUL. 61-156, 1961-2 CUM. BULL. 62. In this ruling the Commissioner states that the transfer of substantially all of the liquidating corporation's assets to transferee in exchange for cash, notes and 45 per cent of transferee's stock constitutes an "E" or an "F" reorganization. In spite of the fact that the Commissioner finds a reorganization here, he holds that the cash and notes received by the shareholders is to be treated as a dividend under section 301, rather than as additional compensation under section 356. The Commissioner cites Treas. Reg. 1.331-1(c) (1955), as authority for taxing this "reorganization" under section 301 (see note 68 *infra*). However, it is clearly held in *Gallagher* that the Tax Court will not look favorably upon such reasoning, and that it is not supported by the statutory provisions. See generally Bauman, *New Clouds on the Liquidation Horizon,* 48 A.B.A.J. 182 (1962).

zation under section 368(a)(1)(D).[57] Second, if we have essentially the same transaction as stated above with a failure to meet the exact, literal requirements of section 368, *e.g.*, statutory control is not in the remaining shareholders of transferor, but there is a valid "business purpose" shown by the taxpayers, then a partial or complete liquidation will be found.[58] Third, a question is raised as to how the court might hold if it were presented with a similar transfer, and with the literal requirements of section 368(a) again not met, and with no valid business purpose shown for the transaction. In such a transaction the taint of tax avoidance becomes more extreme. Fourth, the divergent tax results of two cases so alike in economic effect illustrates how badly corrective legislation is needed in this area.[59]

The import of the decision in *Gallagher* may be to confine the Commissioner's attack on liquidation-reincorporation transactions to the reorganization provisions of the 1954 Code.[60] However, it

[57] Thus the corporation-to-corporation transfer would be tax-free and the new corporation, under section 362(b), would take the assets transferred at the same basis at which the old corporation held them. However, the distributions to the old corporation's shareholders will be taxable, under section 356, to the extent of gain "but not in excess of the sum of such money and the fair market value of the such other property" which is distributed. To the extent that the distribution of other property and cash is attributable to accumulated earnings and profits of the corporation, it is taxable as a dividend under section 356(a)(2). This is in accord with pre-54 decisions. See note 10 *supra* and cases cited therein.

[58] This results in the transferee corporation, under sections 334 and 362(a), receiving the assets of transferor at a stepped-up basis (fair market value), and the distributions of cash and any other remaining assets to the transferor's shareholders at capital gain rates, under section 331, as distributions in liquidation.

[59] A comparison of the results in *Grubbs* and *Gallagher* does not seem to show a sense of justice and fairness in the application of the revenue laws, when the difference in taxability of two transactions which are basically the same is based on so narrow a thread.

> " 'The Law is the true embodiment
> Of everything that's excellent.
> It has no kind of fault or flaw,'
> ...."

Fried, *Two Concepts of Interests: Some Reflections on the Supreme Court's Balancing Test*, 76 HARV. L. REV. 755, 772 n.26 (1963), quoting GILBERT AND SULLIVAN, IOLANTHE, ACT I.

[60] See Note, 32 U. CINC. L. REV. 416 (1963). An appeal of *Gallagher* to the Ninth Circuit has been dismissed. It is reasonable to assume that the government did not perfect its appeal and is waiting for a case whose facts will better present the Commissioner's position. It is interesting to note that the Ninth Circuit has held contra to the Commissioner's position in Braicks

is not likely that the Commissioner will cease in his efforts to use the reincorporation theory to limit the concept of complete liquidation. It would seem that the distinction between the holding in *United States v. General Geophysical Co.*[61] and the *Bazley-Gregory*[62] approach might provide the Commissioner with a platform from which to proceed.

In *General Geophysical* the company had transferred certain depreciable assets, with a tax basis of 170,000 dollars and a fair market value of 750,000 dollars, to two of its major stockholders. Several hours later the company reacquired the assets giving in exchange the company's notes in the amount of 750,000 dollars. The issue in this case was whether or not the company reacquired the assets at a stepped-up basis for purposes of depreciation. There was no question here of the validity of the business purpose involved and the court accepted the contention that the transaction was not prompted by a motive of tax avoidance.[63] In holding that there was not a sufficient interruption in the ownership of the assets to create a new basis, the court stated:

> [T]ax avoidance implications do not constitute a license to courts to distort the laws or to write in new provisions; they do mean that we should guard against giving force to a purported transfer which gives off an unmistakably hollow sound when it is tapped. It is a hollow sound for tax purposes; here, we are not concerned with business purpose or the legal effectiveness of the transaction under [state law] . . . .[64]

Thus, in *General Geophysical* we see a decision which does not question the validity of a transaction for other than tax purposes when there is a valid business purpose involved. However, the court does not allow this to interfere with a proper and just result under the federal revenue laws.

---

v. Henricksen, 43 F. Supp. 254 (W.D. Wash. 1942), *aff'd*, 137 F.2d 632 (9th Cir. 1943).

[61] 296 F.2d 86 (5th Cir.), *petition for rehearing denied* 296 F.2d 90 (5th Cir. 1961).

[62] See text accompanying notes 40-44 *supra*. See generally Bierman & Silverstein (chairmen), *Substance vs. Form in Corporate Activities: A Series of Panel Discussions*, N.Y.U. 20TH INST. ON FED. TAX 975 (1962); Cuddihy, *The Misuse of "Substance" v. "Form"*, U. So. CAL. 1963 TAX INST. 653.

[63] The transaction was carried out in the form illustrated so that the retiring stockholders would not be liable should the corporation become bankrupt. 296 F.2d at 87.

[64] 296 F.2d at 89.

In addition, and notwithstanding the *Gallagher* decision, the *Bazley-Gregory* approach cannot yet be counted out in this area. It would seem to provide the correct result in a case where the transaction was not made for a valid business purpose. In such a case the transaction would have been more clearly made for the purpose of tax avoidance and the court should have no difficulty in holding that such a "sham" transaction should be denied the dignity of a judicial holding that it is valid as regards the federal revenue laws. The "substance and realities" of the situation would prevent the court's giving effect to such a transaction.[65]

The statutory route must now be recognized as the most effective way to remove the problem created in this area by the 1954 Code. The purpose and intent of the revenue laws, although the present statutory provisions do not so provide, seem to require that shareholders continuing in an incorporated enterprise after a liquidation be taxed at ordinary income tax rates, to the extent that the distributions come out of accumulated earnings and profits without regard to the percentage of ownership retained by the continuing shareholder.[66]

The House of Representatives' version of the statute later enacted as the 1954 Code contained a section which was designed to deal with liquidations followed by reincorporations.[67] The proposed section was not enacted, and the managers of the bill in the House indicated that they thought tax avoidance possibilities in this area were not great, and that if such possibilities did present themselves

[65] There is a strong dissent based on this argument in *Gallagher,* 39 T.C. No. 13 at 20.

[66] Most suggested legislation in this area uses fifty per cent as the cut-off point. That is in order to come under the liquidation-reincorporation provisions it is generally thought that the continuing shareholder(s) should have at least fifty per cent of the equity in the transferee corporation. However, it would seem that there are many instances when less than that amount would justify taxation as an ordinary dividend when the minority shareholder(s) remains in the corporate enterprise as a result of a "plan of reorganization" or liquidation. It does not seem improbable that a properly drawn statute, depending on substance rather than form, could provide for such transactions. See generally MacLean, *Problems of Reincorporation and Related Proposals of the Subchapter C Advisory Group,* 13 TAX L. REV. 407 (1958); see note 9 *supra.*

[67] H. R. 8300, 83d CONG., 2d SESS. § 357 (1954). In noting this, the court in *Gallagher* said that for them to find a reorganization would be to "enact that provision which has failed on two separate occasions to be enacted by Congress." 39 T.C. No. 13 at 20.

the judiciary or the regulations could handle the problem by utilizing other provisions of the Code. Unfortunately, the conference committee report by the managers for the House did not indicate which provisions of the Code were meant.[68] From the vantage point of hindsight we are able to see that judicial gloss and administrative provisions cannot, in every case, remove the difficulties caused by legislative oversight.[69] At this point it may be said that:

> [T]he House committee wore rose-tinted glasses, which made impenetrable the darker implications, when it concluded that the "liquidation and reincorporation" problem could be solved by expedients other than legislation. A lack of judicial harmony prevails in the area and the 1954 Code fails to mitigate the resulting unfortunate situation.[70]

We are at an untenable cross-roads in this area. The law concerning liquidation-reincorporation transactions is uncertain and open to abuse. This uncertainty may well produce unjust tax results in the litigation which will probably result before there are sufficient judicial precedents to provide the government and the taxpayer with acceptably definite guidance. Thus, it appears that it is

---

[68] H. R. REP. No. 2543, 83d CONG., 2d SESS. 41 (1954).

The Commissioner sought to utilize what he took to be the "legislative intent" of the Congress on this problem and issued regulations under both sections 301 and 331 of the 1954 Code dealing with the problems in this area. Treas. Reg. § 1.301-1(1) (1955), provides that "a distribution to shareholders with respect to their stock is within the terms of section 301 although it takes place at the same time as another transaction if the distribution is in substance a separate transaction whether or not connected in a formal sense. This is most likely to occur in the case of . . . a reincorporation . . . ." And in Treas. Reg. § 1.331-1(c) (1955), the Commissioner states "a liquidation which is followed by a transfer to another corporation of all or part of the assets of the liquidating corporation or which is preceded by such a transfer may, however, have the effect of the distribution of a dividend or of a transaction in which no loss is recognized and gain is recognized only to the extent of 'other property.'"

In *Gallagher,* application of the step-transaction theory avoided Treas. Reg. § 1.301-1(1), since it requires "in substance a separate transaction . . . ." While in the opinion the court said that since there was no reorganization on the facts presented, Treas. Reg. § 1.331-1(c) would not apply because it merely adopts the holding of Richard H. Survaunt, 5 T.C. 665 (1945), a case involving a liquidation-reincorporation wherein a "D" reorganization was found by the court. 39 T.C. at 19. These pronouncements by the Commissioner would seem to be ineffective indeed when read in the light of the *Gallagher* decision.

[69] MERTENS, CODE COMMENTARY, FEDERAL INCOME TAXATION § 368(a)-(1)(D):1 at 253 (1955).

[70] Bakst, *Does Dissolution Followed by Reincorporation Constitute a Reorganization?,* 33 TAXES 815, 822 (1955).

up to the Congress to erect the signs that are necessary to facilitate predictable passage through this cross-roads.[71]

MARION A. COWELL, JR.

Survey of the United States Supreme Court Decisions Affecting Labor-Management Relations During the 1962-1963 Term*

The labor law decisions of the Supreme Court during the 1962-1963 term were primarily significant in clarifying perennial labor issues. The Court was faced with many recurring problems—jurisdiction of the National Labor Relations Board, federal court preemption, rights under Section 301 of the Taft-Hartley Act, and a union's use of dues for political contributions—and it resolutely drafted new guidelines in an attempt to clarify the existing complexity. But the Court was not entirely relegated to redefining the old problems as it also was called upon for its initial construction of recent significant developments such as the agency shop agreement and superseniority to strike replacements.

The Court took final action on eighty-four labor cases during the term. Twenty-two of these cases were disposed of by opinion, sixty were denied review, one was reversed upon grant of review, and one was remanded with directions to dismiss as moot. The following is a summary of those twenty-two cases on which the Court granted review.

I. JURISDICTION OF THE NLRB

The National Labor Relations Board receives its authority from Congress by way of the National Labor Relations Act.[1] The power

[71] For thorough presentations on the problems herein discussed, and many related problems, see Grubb, *Corporate Manipulations Under Subchapter C: Reincorporation-Liquidation,* 28 U. CINC. L. REV. 304 (1959); Kuhn, *Liquidation and Reincorporation Under the 1954 Code,* 51 GEO. L.J. 96 (1962); MacLean, *Problems of Reincorporation and Related Proposals of the Subchapter C Advisory Group,* 13 TAX L. REV. 407 (1958); Schwartz, *Reincorporation Under The 1954 Code,* 15 U. FLA. L. REV. 159 (1962).

The author acknowledges use of Happer, "The Liquidation-Reincorporation Problem" (unpublished seminar paper, University of North Carolina School of Law, May 1963), as an aid in research. The opinions of that paper do not appear herein except in such case as they coincide with those of the author.

* The author would like to express his sincere appreciation to Professor Daniel H. Pollitt for the encouragement and guidance given in the preparation of this paper.

[1] National Labor Relations Act § 3(a), added by 61 Stat. 139 (1947), as amended, 73 Stat. 542 (1959), 29 U.S.C. § 153 (Supp. III, 1962).

of Congress and thus the NLRB to regulate labor-management relations is limited by the commerce clause of the United States Constitution. The NLRB, therefore, can regulate labor problems only in respect to activities and labor disputes which have a substantial effect on "commerce with foreign Nations, and among the several States . . ."

The Court determined three "commerce clause" cases during the term involving the question of the jurisdiction of the NLRB over the subject matter.

A. Interstate Commerce

In *NLRB v. Reliance Fuel Oil Corp.*[2] a New York fuel oil distributor questioned the jurisdiction of the NLRB over his labor practices, claiming he was a local distributor and was not engaged in interstate commerce. The Board had determined that Reliance had purchased more than 650,000 dollars worth of fuel oil and related products from Gulf Oil Corp., an out-of-state supplier who was concededly engaged in interstate commerce. The Board found that the activities of Reliance affected interstate commerce within the meaning of section 2(7) of the National Labor Relations Act[3] so as to give it jurisdiction over the alleged unfair labor practices of the distributor.

The Supreme Court affirmed, holding that in passing the National Labor Relations Act "Congress intended to and did vest in the Board the fullest *jurisdictional* breadth constitutionally permissible under the Commerce Clause."[4] In finding that the activities of Reliance undoubtedly were within the constitutional reach of Congress, the Court pointed to the fact that "Congress has explicitly regulated not merely transactions or goods in interstate commerce but activities which in isolation might be deemed to be merely local but in the interlacings of business across state lines adversely affect such commerce."[5] The Court found the situation "representative of many others throughout the country, the total incidence of which if left unchecked may well become far-reaching in its harm to commerce."[6]

---

[2] 371 U.S. 224 (1962).

[3] National Labor Relations Act § 2(7), as amended, 61 Stat. 137 (1947), 29 U.S.C. § 152(7) (1958).

[4] 371 U.S. at 226. (Emphasis added.)

[5] *Id.* at 226-27.

[6] *Id.* at 226.

B. Foreign Commerce

It is generally agreed that Congress has the power under the commerce clause to apply the National Labor Relations Act to the crews of foreign-flag ships while they are operating in American waters.[7] But in two successful attacks against the Board's jurisdiction during the term the Court decided that Congress has not exercised such power.

The Court determined in *McCulloch v. Sociedad National de Marineros de Honduras*[8] that under the Taft-Hartley Act the Board had no jurisdiction over foreign-flag ships employing foreign crews, even though the ships were owned by a subsidiary of a United States corporation. The case arose when the Board ordered an election, after petition for certification[9] by the National Maritime Union (NMU), among the crew of a Honduran vessel to determine whether or not they wished to be represented by a union.

The Board discovered that an American corporation, United Fruit Company, owned all the stock of the Honduran corporation, Empresa, which time-chartered the vessels to United Fruit. It also determined that all the crew of the vessels, including officers, were Honduran (except one Jamaican) and claimed that country as their home; and that the crew was controlled by a collective bargaining agreement with a Honduran union. United Fruit, however, directed the use of the vessels. The Board concluded that United Fruit operated a single, integrated maritime operation within which were the Empresa vessels, reasoning that United Fruit was a joint employer with Empresa of the seamen covered by NMU's petition. Using a "balance of contacts" test, it concluded that the maritime operations involved substantial United States contacts, outweighing the numerous foreign contacts present, and that the Board had jurisdiction.[10] The Court of Appeals reversed.[11]

In argument before the Supreme Court the Board attempted to distinguish a prior case, *Benz v. Compania Naviera Hidalgo, S.A.*[12]

[7] Benz v. Compania Naviera Hidalgo, 353 U.S. 138 (1957); Weldenhus' Case, 120 U.S. 1 (1887); The Exchange v. McFadden, 11 U.S. (7 Cranch) 116 (1812).

[8] 372 U.S. 10 (1962).

[9] National Labor Relations Act § 9(c), added by 61 Stat. 143 (1947), as amended, 73 Stat. 542 (1959), 29 U.S.C. 159(3) (Supp. III, 1962).

[10] United Fruit Co. v. National Maritime Union, 134 NLRB 287 (1961).

[11] 300 F.2d 222 (2d Cir. 1962).

[12] 353 U.S. 138 (1957).

In that case the Court held that the Taft-Hartley Act did not apply in a suit for damages "resulting from the picketing of a foreign ship operated entirely by foreign seamen . . . while the vessel was temporarily in an American port.[13] . . . [Congress] inescapably describes the boundaries of the Act as including only the workingmen of our own country and its possessions."[14] In distinguishing, the Board urged that unlike the vessel in the *Benz* case (1) these United Fruit vessels were not temporarily in United States waters, but were operating in a regular course of trade between foreign ports and the United States, and (2) the foreign owner was in turn owned by an American corporation.[15]

The Court voted down the Board's argument and its balance of contacts test:

> We note that both of these points rely on additional American contacts and therefore necessarily presume the validity of the "balancing of contacts" theory of the Board. But to follow such a suggested procedure to the ultimate might require that the Board inquire into the internal discipline and order of all foreign vessels calling at American ports. Such activity would raise considerable disturbance not only in the field of maritime law but in our international relations as well. In addition, enforcement of Board orders would project the courts into application of the sanctions of the Act to foreign-flag ships on a purely *ad hoc* weighing of contacts basis. This would inevitably lead to embarrasement in foreign affairs and be entirely infeasible in actual practice.[16]

The Court concluded that for it to "sanction the exercise of local sovereignty under such conditions in this 'delicate field of international relations there must be present the affirmative intention of the Congress clearly expressed,' "[17] and that there is no specific language in the Taft-Hartley Act or in its legislative history including foreign vessels within its coverage.[18]

The Court then applied its *Sociedad* decision to *Incres S. S. Co. v. IMWU*,[19] which was granted certiorari with *Sociedad*. It held that since the National Labor Relations Act does not apply to foreign-reg-

[13] *Id.* at 139.
[14] *Id.* at 144.
[15] 372 U.S. at 18-19.
[16] *Id.* at 19.
[17] *Id.* at 21-22.
[18] *Id.* at 19.
[19] 372 U.S. 24 (1963).

istered ships employing alien seamen, a state court has jurisdiction of an action for damages and injunctive relief brought by such a ship-owner against a United States union for picketing during a campaign to organize.

The Court reversed the New York court decision[20] that the Labor Board had exclusive jurisdiction. Although it was "arguable" at the time of the trial court's decision that the Board's jurisdiction extended to this dispute, the decision in *Sociedad* negated such jurisdiction now. "The Board's jurisdiction to prevent unfair labor practices, like its jurisdiction to direct elections, is based upon circumstances 'affecting commerce,' and we have concluded that maritime operations of foreign-flag ships employing alien seamen are not in 'commerce' within the meaning of § 2(6)...."[21]

II. State Legislation

As indicated by the New York court decision in *Incres,* one of the major objectives of the National Labor Relations Act is to provide an element of uniformity and certainty in the conduct of labor relations. To this end the United States Supreme Court has acted to strike down state legislation which attempts to interfere with the federal law. During the past term the Court heard five cases which questioned the validity of state statutes in view of their potential conflict with the national labor policy.

A. Anti-Discrimination Statute

The Court held in *Colorado Anti-Discrimination Comm'n v. Continental Airlines, Inc.*[22] that state laws forbidding racial discrimination in hiring practices may be applied to airlines and other interstate employers. The Court reversed the Colorado Supreme Court,[23] and commanded affirmance of the Colorado Anti-Discrimination Commission's order that Continental Airlines hire a licensed and qualified Negro pilot.

The Airline argued that this state law would burden commerce through conflicting and diverse regulations. The Court answered

[20] Incres S.S. Co. v. IMWU, 10 N.Y.2d 218, 176 N.E.2d 719 (1961).
[21] 372 U.S. at 27.
[22] 372 U.S. 714 (1963).
[23] Colorado Anti-Discrimination Comm'n v. Continental Airlines, Inc., 368 P.2d 970 (Colo. 1962).

this by pointing out that there was no federal conflict involved in a state statute forbidding racial discrimination in hiring. It stated in essence that the threat of diverse and conflicting regulation of a carrier's hiring practices is virtually nonexistent since any state or federal law requiring a carrier to practice racial discrimination in hiring would be invalid as unconstitutional.[24]

The Airline vigorously argued that the federal law has so pervasively covered the field of protecting people in interstate commerce from racial discrimination, that the states are barred from enacting legislation in this field. Justice Black rejected this preemption contention, pointing to the federal law referred to by the Airline. He made these points:

(1) Although the Federal Aviation Act contains broad general provisions against unjust discrimination, neither the Federal Aviation Agency nor the Civil Aeronautics Board have assumed the authority to prohibit racial discrimination by air carriers. There can be no preemption as long as such power remains dormant and unexercised.[25]

(2) Nothing in the Railway Labor Act places upon the employer a duty to engage in fair employment practices.[26]

(3) Presidential Executive Orders requiring government contractors to include non-discriminatory pledges in their contracts cannot be held to have preempted the field. Even assuming that the Executive Order could foreclose state legislation, "it is impossible for us to believe that the Executive intended for its order to regulate air carrier discrimination among employees so pervasively as to preempt state legislation intended to accomplish the same purpose."[27]

Thus, the Court's opinion makes it clear that state anti-discrimination laws are not to be regarded as threatening interstate carriers with conflicting and diverse regulations which would burden commerce, and that such laws are not preempted by federal regulation. The decision permits states to require interstate employers to adhere to state enacted fair employment practice legislation.

---

[24] 372 U.S. at 721.

[25] *Id.* at 723-24.

[26] *Id.* at 724. The Railway Labor Act applies to airlines as well as to railroads. Railway Labor Act § 201, as amended, 49 Stat. 1189 (1936), 45 U.S.C. § 181 (1958).

[27] *Id.* at 725.

B. Public Utility Strike Law

States cannot require employees to forego the federally guaranteed right to strike, even in industries of local importance.[28] This position was reiterated this past term when the Court invalidated Missouri's King-Thompson Act[29] in *Amalgamated Ass'n of Street Employees v. Missouri*.[30] The King-Thompson Act authorized the state to seize struck public utilities and to forbid strikes thereafter.[31] The Governor of Missouri utilized the statute in thwarting a strike against a Kansas-Missouri transit company.

The Court found the statute unconstitutional under the supremacy clause, declaring

> The short of the matter is that Missouri, through the fiction of "seizure" by the State, has made a peaceful strike against a public utility unlawful, in direct conflict with federal legislation which guarantees the right to strike against a public utility, as against any employer engaged in interstate commerce. In forbidding a strike against an employer covered by the National Labor Relations Act, Missouri has forbidden the exercise of rights explicitly protected by § 7 of that Act. Collective bargaining, with the right to strike at its core, is the essence of the federal scheme.[32]

---

[28] In Amalgamated Ass'n of Street Employees v. Wisconsin Employment Relations Bd., 340 U.S. 383 (1951), the Court held invalid under the Supremacy Clause a Wisconsin statute which made it a misdemeanor for any group of public utility employees to engage in a strike which would cause an interruption of an essential public utility service.

[29] Mo. REV. STAT. 295.180 to -.200 (1959).

[30] 374 U.S. 74 (1963).

[31] Mo. REV. STAT. 295.180 to -.200 (1959). Section 295.180 authorizes seizure by the state.

Section 295.200(1) provides: "It shall be unlawful for any person, employee, or representative as defined in this chapter to call, incite, support or participate in any strike or concerted refusal to work for any utility or for the state after any plant, equipment or facility has been taken over by the state under this chapter, as means of enforcing any demands against the utility or against the state."

Section 295.200(6) provides: "The courts of this state shall have power to enforce by injunction or other legal or equitable remedies any provision of this chapter or any rule or regulation prescribed by the governor hereunder."

The Taft-Hartley Act excludes from its coverage employees of any state or political subdivision thereof. National Labor Relations Act § 2(2), as amended, 61 Stat. 137 (1947), 29 U.S.C. § 152(7) (1958). But in the instant case the Court found that the transit company employees did not in actuality become employees of the State. No property of the company was actually conveyed, transferred, or otherwise turned over to the State. The State did not in any way participate in the management of the company's business.

[32] 374 U.S. at 82. This right to strike is not unlimited. The Taft-Hartley Act §§ 206-210, 61 Stat. 155 (1947), 29 U.S.C. § 176-180 (1958), allows the

C. Picketing By Non-Employees

A Virginia statute[33] prohibiting picketing by non-employees was held unconstitutional in *Waxman v. Virginia*.[34] By a per curiam order the Court reversed a Virginia Supreme Court of Appeals[35] decision which held that neither the Taft-Hartley Act nor the first amendment prevents the state from prohibiting picketing by non-employees. The Supreme Court first held to the contrary over twenty-three years ago in *AFL v. Swing*.[36]

D. Right-To-Work Laws

A union, as a social institution, is dependent for its continued existence upon its ability to meet the particular needs of its members. To meet these needs a union must have the strength to obtain rights for itself as an organization. A usual method of obtaining such strength is through "union-security agreements" contained in collective bargaining contracts. The "closed-shop agreement" was the strongest form of union-security. It provided that the employer could hire only members of a specific union, and that the employer would discharge any employee who did not remain a member in good standing throughout the life of the agreement. But this form of union-security was abolished in 1947 by section 8(a)(3) of the Taft-Hartley Amendments.[37]

President of the United States to take action, by injunction through a district court if necessary, to halt a threatened or actual strike or lock-out affecting an entire industry, or a substantial part of commerce, or which, if permitted to continue will imperil the national health or safety. See, United Steelworkers v. United States, 361 U.S. 39 (1959). See generally, McDermott, *Ten Years of the National Emergency Procedure*, 9 LAB. L.J. 227 (1958); Rehmus, *Operation of the National Emergency Provisions of Taft-Hartley*, 62 YALE L.J. 1047 (1953).

[33] VA. CODE ANN. § 40-64 (1953): "When a strike or lock-out is in progress, no person who is not, or immediately prior to the time of the commencement of any strike or lock-out was not, a bona fide employee of the business or industry being picketed shall participate in any picketing or any picketing activity with respect to such strike or lock-out."

[34] 371 U.S. 4 (1962).

[35] Waxman v. Virginia, 203 Va. 257, 123 S.E.2d 381 (1962).

[36] 312 U.S. 321 (1941).

[37] National Labor Relations Act § 8(a)(3), added by 61 Stat. 140 (1947), as amended, 73 Stat. 525 (1959), 29 U.S.C. § 158(a)(3) (Supp. III, 1962). Section 8(a)(3) makes it an unfair labor practice for an employer to discriminate against employees in regard to hire or tenure of employment for the purpose of encouraging or discouraging membership in a labor organization. Union-security clauses necessarily discriminate against non-union employees and encourage membership in unions. Thus when an employer agrees to a union-security clause, he would be committing an unfair labor practice

Section 8(a)(3) does permit, under certain conditions, other forms of union-security agreements. A union and an employer may make an agreement requiring all employees to join the union in order to retain their jobs. This is the "union-shop agreement."[38] But the Taft-Hartley Act severely limited the application of union-shop agreements in section 14(b), which declares that nothing in the federal statute authorizes the execution or application of union-security agreements in any state or territory "in which such execution or application is prohibited by State or Territorial law."[39] This section in effect, has carved out an exception to the preemption doctrine for state right-to-work laws.

Another form of "union-security" is the "agency-shop" agreement. Under this arrangement membership in the union is not compulsory, but non-union employees of the bargaining unit are required to pay support money to defray their share of the bargaining expenses of the union. The union justifies this because it is required to bargain for and represent *all* the employees of the unit regardless of their union affiliation. In unanimous decisions during the past term, the Court resolved two much-litigated issues involving the validity of agency-shop agreements in the face of state right-to-work laws.

The Indiana right-to-work law[40] was the point of departure in

---

under §8(a)(3). But Congress permitted some union-security agreements by enacting a proviso which exempts the union-shop from the reaches of §8(a)(3). This exemption, however, does not include the closed-shop contract.

[38] A lawful union-shop agreement can not require that applicants for employment be members of the union in order to be hired. The most that can be required is that all employees in the group covered by the agreement become members of the union within a certain period of time after the contract takes effect. Membership may be required only after thirty days following the effective date of the contract or the beginning of the employment, whichever is later. The union is also required to admit all eligible employees to membership without discrimination, although the union reserves the right to make its own rules of eligibility. The union may seek an employee's discharge for non-membership only when membership has been withdrawn for failure to tender an initiation fee or periodic dues. If the employer has reasonable cause to believe that membership was denied or terminated for any other reason, discharge for membership may be an unfair labor practice on the part of either the employer or the union, or both, depending on the circumstances of the case. See generally, *Symposium—Union Security Under the Taft-Hartley Act*, 11 SYRACUSE L. REV. 37 (1959).

[39] Labor Management Relations Act (Taft-Hartley Act) §14(b), 61 Stat. 151 (1947), 29 U.S.C. §164 (b) (1958).

[40] IND. ANN. STAT. §§ 40-2701 to -2705 (Supp. 1961). Section 40-2701

NLRB v. General Motors Corp.[41] The Indiana statute had been construed by an Indiana Appellate Court in *Meade v. Hagberg*[42] as permitting agency-shop agreements. That court pointed out that there are two types of right-to-work statutes in this country—(1) those which prohibit the compulsory paying of fees to labor organizations, and (2) those which prohibit only the conditioning of employment on union membership. The Indiana statute is of the latter type. Since both types of statutes existed prior to the Indiana statute, the court stated that

> it would seem that the clear, unequivocal language of the Indiana act was intended to apply to union membership and not to outlaw "agency-shop" agreements which provide for the payment of fees and dues to labor organizations properly designated as collective bargaining representatives. Had the legislature intended to make such provisions and such conduct illegal it should have so expressly declared in the language of the act.[43]

After the *Meade* case was decided, the United Auto Workers demanded that a General Motors plant in Indiana bargain on the same type agency-shop agreement as in *Meade*. General Motors refused to bargain, claiming the agency-shop was an unfair labor practice under federal law. The union filed a refusal to bargain charge with the NLRB. The Board found[44] the agency-shop is a lawful subject of bargaining, but the Court of Appeals reversed.[45]

---

provides: "Public Policy. It is hereby declared to be the public policy of the state of Indiana that membership or nonmembership in a labor organization should not be made a condition to the right to work or to become an employee of or to continue in the employment of any employer... and any agreements between employers and labor organizations which make membership or the maintenance thereof, or nonmembership, in a labor organization a condition of employment or continued employment, and any denial, severance or interruption of employment because of such membership or nonmembership are violations of said rights and are against the public policy of the state of Indiana."

Section 40-2703 prohibits any agreement by an employer or a labor organization to exclude or discharge an employee by reason of membership or nonmembership in a labor organization.

Section 40-2704 prohibits any conduct which encourages exclusion or discharge of an employee by reason of membership or nonmembership in a labor organization.

Section 40-2705 declares violations of the provisions of the act shall be a misdemeanor.

[41] 373 U.S. 734 (1963).

[42] 129 Ind. App. 631, 159 N.E.2d 408 (1959).

[43] *Id.* at —, 159 N.E.2d at 414.

[44] General Motors Corp. v. UAW, 133 NLRB 451 (1961).

[45] General Motors Corp. v. NLRB, 303 F.2d 428 (6th Cir. 1962).

The Supreme Court reversed, holding that an agency-shop constitutes a permissible form of union-security under the Taft-Hartley Act. Therefore, the employer was not excused from his duty under the Act to bargain over an agency-shop proposal.

The Court referred to its language in *Radio Officers Union v. NLRB*,[46] where it had determined that the legislative history of section 8(a)(3) indicates that

> Congress recognized the validity of unions' concern about free riders, *i.e.*, employees who receive the benefits of union representation but are unwilling to contribute their fair share of financial support to such union, and gave unions the power to contract to meet that problem while withholding from unions the power to cause the discharge of employees for any other reason.[47]

The Court pointed out that an agency-shop contract is the practical equivalent of a union-shop contract, since in both the employment is conditioned on the employee's payment of an amount equal to the union dues and fees. The Court found that the only substantial difference between the union-shop and the agency-shop is that the former puts the option of choice of membership on the employer, where the latter places that choice on the employee. "Such a difference between the union and agency shop may be of great importance in some contexts, but for present purposes it is more formal than real."[48]

In *Retail Clerks Int'l Ass'n v. Schermerhorn*,[49] the Court found that since the agency-shop is within the sanction of section 8(a)(3) as found in *General Motors*, it is also within the scope of section 14(b). Therefore a state is within its authority under section 14(b) in invalidating union-shop and agency-shop contracts where such contracts are contrary to state law. Since Florida, in the instant case,[50] had held the agency-shop contract invalid under its right-to-work law,[51] the Court dismissed the appeal. But the Court restored

[46] 347 U.S. 17 (1954).

[47] 373 U.S. at 742-43 (1963), quoting from Radio Officer's Union v. NLRB, 347 U.S. at 41 (1954).

[48] *Id.* at 744.

[49] 373 U.S. 746 (1963).

[50] Retail Clerks Int'l Ass'n v. Schermerhorn, 141 So. 2d 269 (Fla. 1962).

[51] FLA. CONST. § 12: "The right of persons to work shall not be denied or abridged on account of membership or nonmembership in any labor union, or labor organization; provided, that this clause shall not be construed to deny or abridge the right of employees by and through a labor organization or labor union to bargain collectively with their employer."

the case to the calendar for reargument as to whether the Florida courts, rather than exclusively the NLRB, are tribunals with jurisdiction to enforce the state's prohibition against such arrangements.[52]

Thus the Court substantially removed many doubts as to the application of state right-to-work laws to the agency-shop agreement. Future agreements can be entered into with more predictability in following the teachings of these cases:

(1) An agency-shop agreement is not an unfair labor practice, but rather is a valid form of union-security agreement within section 8(a)(3) of the NLRA.
(2) Since an agency-shop agreement is within section 8(a)(3), it is also within the preemption exception of section 14(b).
(3) Not all state right-to-work laws prohibit agency-shop agreements, as shown in the construction given the Indiana statute.

III. Federal Preemption

Since the Wagner Act in 1935,[53] the Court has been called upon to determine the extent to which state labor regulation must yield to overriding federal authority. The Court has concerned itself with the potential conflict between federal and state systems—their inconsistent standards of substantive law and their differing remedial schemes. The unifying consideration of the Court's decisions has been "regard to the fact that Congress has entrusted administration of the labor policy for the Nation to a centralized administrative agency, armed with its own procedures, and equipped with its specialized knowledge and cumulative experience."[54]

In *Garner v. Teamsters Union*,[55] the Court explained:

> Congress did not merely lay down a substantive rule of law to be enforced by any tribunal competent to apply law generally to the parties. It went on to confide primary interpretation and application of its rules to a specific and specially constituted tribunal and prescribed a particular procedure for investigation, complaint and notice, and hearing and decision, including judicial

[52] On Dec. 3, 1963, the Court held that the state court has jurisdiction to enforce its state right-to-work law's prohibition against the agency shop clause. Retail Clerks Int'l Ass'n v. Schermerhorn, 32 U.S.L. Week 4018 (U.S. Dec. 3, 1963).

[53] National Labor Relations Act, 49 Stat. 449 (1935) (now 29 U.S.C. § 151) (1958).

[54] San Diego Bldg. Trades Council v. Garmon, 359 U.S. 236, 242 (1959).

[55] 346 U.S. 485 (1953).

> relief pending a final administrative order. Congress evidently considered that centralized administration of specially designed procedures was necessary to obtain uniform application of its substantive rules and to avoid those diversities and conflicts likely to result from a variety of local procedures and attitudes toward labor controversies.... A multiplicity of tribunals and a diversity of procedures are quite as apt to produce incompatible or conflicting adjudications as are different rules of substantive law.[56]

In complying with the congressional intention, the Court has adopted the doctrine of federal preemption in labor cases.

The principles making up the doctrine of federal preemption were aptly summarized by the Court in its opinion in *San Diego Bldg. Trades Council v. Garmon,*[57] as follows:

(1) "When an activity is arguably subject to § 7 or § 8 of the Act, the States as well as the federal courts must defer to the exclusive competence of the National Labor Relations Board if the danger of state interference with national policy is to be averted."[58]
(2) The initial determination of whether a particular activity is subject to the Act is exclusively the responsibility of the NLRB.[59]
(3) The failure of the NLRB to determine the status of the disputed activity does not necessarily give the state the power to act.[60]
(4) State regulation is precluded regardless of the remedy sought, if the conduct to be remedied is potentially subject to the Taft-Hartley Act. The doctrine applies to damage awards as well as to injunctions, to state court proceedings as well as to regulation by state labor agencies, and to actions based on general statutory or common law as well as to proceedings under a state labor relations statute.[61]

The *Garmon* rule was clear and concise. It charted a simple and direct course of conduct for state courts to follow. It seemingly performed the invaluable task of warning state judges to stay out of the field of regulating strikes, boycotts and picketing which comes within the jurisdiction of the NLRB. But the warning has fallen

[56] *Id.* at 490-91.
[57] 359 U.S. 236 (1959).
[58] *Id.* at 245.
[59] *Ibid.*
[60] *Id.* at 245-46.
[61] *Id.* at 246-47.

on some unheeding ears, and the Court decided four cases during the past term by utilizing the *Garmon* principles of federal preemption.

In *Local 438, Constr. Union v. Curry*,[62] a Georgia non-union contractor brought suit against a union for picketing the construction site for the purpose of forcing him to hire only union labor. He sought a temporary injunction, but it was denied without opinion. On appeal the Georgia Supreme Court reversed,[63] holding that the Georgia Superior Court had jurisdiction to issue the temporary injunction. On writ of certiorari the United States Supreme Court reversed, ruling that the picketing involved an arguable violation of the Taft-Hartley Act and that the NLRB has exclusive primary jurisdiction. Because of the doctrine of federal preemption, the Georgia Supreme Court had no jurisdiction to issue a temporary injunction against the picketing.[64]

---

[62] 371 U.S. 542 (1963).

[63] Curry v. Construction Union, 217 Ga. 512, 123 S.E.2d 653 (1962).

[64] The Court found that the allegations of the complaint, as well as the findings of the Georgia Supreme Court, made out at least an arguable violation of § 8(b) of the Taft-Hartley Act. The Georgia court had said the picketing was for the purpose of forcing respondents to employ only union labor and that the picketing therefore violated the Georgia right-to-work law. On the other hand, the union contended that its peaceful picketing was for the sole purpose of publicizing the facts about the wages paid by the contractor. In finding preemption applicable, the Court pointed to several specific provisions which the NLRB may find were violated:

Section 8(b)(1)(A) prohibits unions from restraining or coercing employees in the exercise of their rights under § 7 of Taft-Hartley;

Section 8(b)(2) prohibits unions from causing or attempting to cause discrimination by an employer against an employee;

Section 8(b)(4)(B) prohibits secondary boycotts by unions;

Section 8(b)(7)(C) prohibits organizational and recognitional picketing by non-certified unions unless a representation petition is filed within a reasonable period of time not to exceed thirty days from the commencement of such picketing.

In another aspect of the case, the Court was faced with the initial task of establishing its own jurisdiction over the controversy. 28 U.S.C. § 1257 (1958) limits the Court's appellate jurisdiction to the review of *final* judgments of state courts, and the state court here had issued only a temporary injunction. The Court decided it could review because the judgment constituted a final and erroneous assertion of jurisdiction by a state court beyond its power and in the face of a substantial claim that its jurisdiction is preempted by federal law.

In support of its decision to take jurisdiction, the Court said that a temporary injunction effectively may dispose of the union's rights and render illusory its right to review as well as its right to a hearing before the NLRB. The Court continued, "the policy... against fragmenting and prolonging litigation and against piecemeal reviews of state court judgments does not

In *Local 100, United Ass'n of Journeymen v. Borden*[65] a union member sought damages in a state court against his union for refusal to refer him to a job upon request by the employer. The member alleged that the union had discriminatorily interfered with his right to contract, and had breached a promise implied in the union contract not to discriminate unfairly. The union asserted that Borden had violated an internal union rule prohibiting solicitation of work, and therefore was not eligible for referral. The state court found for Borden.[66] The Supreme Court reversed on the basis of the *Garmon* rule.

> [I]n the absence of an overriding state interest such as that involved in the maintenance of domestic peace, state courts must defer to the exclusive competence of the National Labor Relations Board in cases in which the activity that is the subject matter of the litigation is arguably subject to the protections of § 7 or the prohibitions of § 8 of the National Labor Relations Act. This relinquishment of state jurisdiction . . . is essential 'if the danger of state interference with national policy is to be averted,' . . . and is as necessary in a suit for damages as in a suit seeking equitable relief.[67]

The Court asserted that the conduct here was subject to NLRB cognizance. "[I]t is certainly 'arguable' that the union's conduct violated § 8(b)(1)(A) . . . and 8(b)(2)"[68] in refusing to refer

---

prohibit our holding the decision of the Georgia Supreme Court to be a final judgment, particularly when postponing review would seriously erode the national labor policy requiring the subject matter of respondent's cause to be heard by the National Labor Relations Board, not by the state courts." 371 U.S. at 550.

The Georgia Court had already resolved the merits of the issues raised in the course of the hearing upon the temporary injunction. The petitioner admitted that there were no further factual or legal issues to be solved by the Georgia trial court. "Since there was nothing more of substance to be decided in the trial court, the judgment below was final within the meaning of 28 U.S.C. § 1257 . . . ." 371 U.S. at 551.

The decision is significant in providing for a "speeding-up" of the time-consuming process of appealing a picketing injunction through the state courts and then to the Supreme Court. It will no longer be necessary to wait until a permanent injunction is issued; the appeal may be taken on the temporary injunction.

[65] 373 U.S. 690 (1963).

[66] Local 100, United Ass'n of Journeymen v. Borden, 355 S.W.2d 729 (Tex. Civ. App. 1962).

[67] 373 U.S. at 693-94.

[68] *Id.* at 694. Section 8(b)(1)(A) makes it an unfair labor practice for a labor organization to restrain or coerce an employee in the exercise of his rights

Borden. "And there is a substantial possibility in this case that Borden's failure to live up to the internal rule prohibiting the solicitation of work from any contractor was precisely the reason why clearance was denied."[69] Thus the Board may find that the union conduct was protected concerted activity within section 7. "It is sufficient for present purposes to find, as we do, that it is reasonably 'arguable' that the matter comes within the Board's jurisdiction."[70]

In *Local 207, Int'l Ass'n of Bridge Workers v. Perko*,[71] the plaintiff union member sued in a state court for damages for an illegal conspiracy which led to his being discharged. Perko had worked as a foreman and superintendent and was suspended for violating a union rule, and was thereafter laid off by the company at the union's insistence. The Court held that the subject matter of the action was arguably within the jurisdiction of the NLRB to deal with unfair labor practices, and that the state court had no jurisdiction over the controversy.

> [I]t may well be that a union's insistence on discharge of a supervisor for failure to comply with union rules would violate § 8(b)(1)(A) because it would inevitably tend to coerce nonsupervisory employees into observing those rules. If so, it would surely be within the Board's power under § 10(c) to order the union to reimburse the supervisor for lost wages.
>
> Moreover, if a union forces an employer to discharge a supervisor, such conduct may well violate 8(b)(1)(B) because it coerces the "employer in the selection of his representatives for the purposes of collective bargaining or the adjustment of grievances."[72]

In *Ex parte George*,[73] a Texas court issued a temporary injunction restraining the National Maritime Union and its officers from peacefully picketing a refinery operated by a subsidiary of an oil

---

under § 7 of the Taft-Hartley Act. (Section 7 gives employees the right to self-organization, to bargain collectively, to join labor unions, to strike for better working conditions, and to refrain from activity in behalf of a union.)

Section 8(b)(2) makes it an unfair labor practice for a labor organization to cause an employer to discriminate against an employee in regard to wages, hours, and other conditions of employment for the purpose of encouraging or discouraging membership in a labor organization.

[69] *Id.* at 695.

[70] *Id.* at 696.

[71] 373 U.S. 701 (1963).

[72] *Id.* at 707.

[73] 371 U.S. 72 (1962).

company with which the NMU was engaged in a labor dispute.[74] It found the subsidiary had a valid collective bargaining agreement with another union and that the object of NMU's picketing was to secure the breach of the collective bargaining agreement, in violation of a Texas statute.[75] When the picketing continued, the NMU was adjudged in contempt, and the Texas Supreme Court affirmed, ruling that such picketing was neither prohibited nor protected by the Taft-Hartley Act.

On certiorari, the Court held that the peaceful picketing was at least arguably protected by section 7 of the NLRA and that the state court was therefore without jurisdiction to issue the injunction. "In the absence of the Board's clear determination that an activity is neither protected nor prohibited or of compelling precedent applied to essentially undisputed facts, it is not for this Court to decide whether such activities are subject to state jurisdiction."[76]

IV. Section 301 Exception to the Preemption Doctrine

In *Smith v. Evening News Ass'n*,[77] the Court definitely established that the preemption doctrine does not apply to suits brought under section 301(a) of the Taft-Hartley Act,[78] even when the action complained of is admittedly an unfair labor practice.

Section 301(a) was enacted in 1947 to give federal district courts jurisdiction over suits for violation of certain specified types of collective bargaining contracts. It was thereafter contended that the state courts were preempted from subject matter jurisdiction because of that section. The Court in *Dowd Box Co. v. Courtney*[79] disallowed that argument. It found that the statute provided only that suits *may* be brought in federal district courts, not that they *must* be. The statute did not even *suggest* that federal jurisdiction be exclusive.

---

[74] *Ex parte* George, 163 Tex. 103, 358 S.W.2d 590 (1962).

[75] Tex. Rev. Civ. Stat. Ann. art. 5154d, § 4 (Vernon 1962).

[76] 371 U.S. at 73.

[77] 371 U.S. 195 (1962).

[78] Labor Management Relations Act (Taft-Hartley Act) § 301(a), 61 Stat. 156 (1947), 29 U.S.C. § 185(a) (1958): "Suits for violation of contracts between an employer and a labor organization representing employees in an industry affecting commerce as defined in this Act, or between any such labor organizations, may be brought in any district court of the United States having jurisdiction of the parties, without respect to the amount in controversy or without regard to the citizenship of the parties." See generally Annot. 17 A.L.R.2d 614 (1951).

[79] 368 U.S. 502 (1961).

> The legislative history makes clear that the basic purpose of the § 301(a) was not to limit, but to expand, the availability of forums for the enforcement of contracts made by labor organizations. Moreover, there is explicit evidence that Congress expressly intended not to encroach upon the existing jurisdiction of the state courts.[80]

The Court found that, "instead, Congress deliberately chose to leave the enforcement of collective agreements to the usual processes of the law."[81]

Then in *Local 174, Teamsters Union v. Lucas Flour Co.*[82] the Court established dicta from *Dowd Box* that the state courts in section 301 cases must apply the principles of the federal labor law policy.

In *Evening News,* a suit was brought under section 301 by a union member in a Michigan court against his employer, alleging breach of a collective bargaining agreement in discriminating against him in favor of non-union employees. Both the trial court and the Michigan Supreme Court[83] dismissed the action on the theory of preemption, since the action made out an unfair labor practice and was arguably within NLRB jurisdiction. The United States Supreme Court reversed. It consolidated its holdings in *Dowd Box* and *Lucas Flour* that the preemption doctrine is not relevant in section 301(a) suits, and the state court is free to apply federal law.

Thus the Court seemed to definitely establish a tort-contract distinction, leaving the *Garmon* decision intact as to torts which also involve unfair labor practices, and excepting contracts so that state courts have concurrent jurisdiction with federal courts in applying federal substantive law of collective bargaining.

In reaching the decision the Court overruled its decision in *Association of Westinghouse Salaried Employees v. Westinghouse*[84] on another point. That case held that section 301 did not apply to the enforcement of the personal rights of individual union members by either the unions or the members. The Court in the instant case determined that this holding was based on the misconception that section 301 was merely procedural in nature for the benefit of the

[80] *Id.* at 508-09.
[81] *Id.* at 513.
[82] 369 U.S. 95 (1961).
[83] Smith v. Evening News Ass'n, 362 Mich. 350, 106 N.W.2d 785 (1962).
[84] 348 U.S. 437 (1955).

signatory parties to the collective bargaining contract. The Court pointed out that *Textile Workers v. Lincoln Mills*[85] has

> long since settled that § 301 has substantive content and that Congress has directed the courts to formulate and apply federal law to suits for violation of collective bargaining contracts.... Individual claims lie at the heart of the grievance and arbitration machinery, are to a large degree inevitably intertwined with union interests and many times precipitate grave questions concerning the interpretation and enforceability of the collective bargaining contract on which they are based. To exclude these claims from the ambit of § 301 would stultify the congressional policy of having the administration of collective bargaining contracts accomplished under a uniform body of federal substantive law.[86]

A subsequent case during the term reiterated the *Evening News* decision that section 301(a) gives jurisdiction to enforce individual employee rights. In *General Drivers Union v. Riss & Co.*[87] the Court held that section 301(a) gives a United States District Court jurisdiction to enforce a final and binding grievance procedure award requiring reinstatement of discharged employees with full back pay and seniority to the time of reinstatement, as long as the award is the parties' chosen instrument for the definitive settlement of grievances under the collective bargaining agreement.

V. Co-ordination of Labor Policy with Government Agencies

Just as the Supreme Court has concerned itself with the doctrine of federal preemption in order to eliminate the frustration of the purposes of federal labor legislation, it has been cognizant of the problems of co-ordinating government agencies so as to best achieve the Congressional purposes. This problem was before the Court in two cases during the term.

In *Los Angeles Meat and Provision Drivers Union v. United States,*[88] the conflict was between the federal labor policy and the anti-trust laws. Section 6 of the Clayton Act[89] specifically exempts labor organizations from the reach of the anti-trust laws, and sec-

[85] 353 U.S. 448 (1957).
[86] 371 U.S. at 199-200.
[87] 372 U.S. 517 (1962).
[88] 371 U.S. 94 (1962).
[89] Clayton Act § 6, 38 Stat. 731 (1914), 15 U.S.C. § 17 (1958).

tion 4 of the Norris-LaGuardia Act[90] prevents federal courts from entering injunctions in "labor disputes."

Here, "grease-peddlers" purchased grease from restaurants, hotels, etc., and sold it to processors. The grease-peddlers were mere middlemen in the transaction and made their living from the profit margin on the resale. Four of the grease-peddlers joined the Teamster local to fix prices at a higher profit margin. The union agents enforced the prices by threatening the exercise of union economic power in the form of strikes and boycotts against any processor who dealt with non-union grease-peddlers. The Justice Department brought suit under section 1 of the Sherman Act.[91] The district court found[92] there was a violation of the anti-trust law, enjoined such further action, and in addition directed the termination of the grease-peddlers' union membership. The union appealed the termination order.[93]

The Supreme Court affirmed, holding that businessmen who combine in unreasonable restraint of trade in violation of the Sherman Act can not immunize themselves from that sanction by calling themselves a labor union. The Court could not find any job or wage competition or economic relationship justifying the grease-peddlers' membership in the union. Rather, the Court found they were organized into the union solely to enable them to use the union as an enforcer of a cartel to fix the price and allocate the market. The case did not involve a labor dispute, but involved an "illegal combination between businessmen and a union to restrain trade."[94]

Mr. Justice Douglas dissented.[95] He felt there was a labor dispute within the meaning of the Norris-LaGuardia Act, and that therefore the federal court had no power to compel the grease-peddlers to terminate their union membership. Moreover, in *Allen*

[90] Norris-LaGuardia Act § 4, 47 Stat. 70 (1932), 29 U.S.C. § 101 (1958).

[91] Sherman Act § 1, 69 Stat. 282 (1955), 15 U.S.C. § 1 (1958), amending 26 Stat. 209 (1890). "Every contract, combination in the form of a trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal..."

[92] U.S. v. Los Angeles Meat and Provision Drivers Union, 196 F. Supp. 12 (S.D. Cal. 1961).

[93] In anti-trust cases where the United States is the complainant, 15 U.S.C. § 29 (1958) requires a direct appeal from the district court to the Supreme Court.

[94] 371 U.S. at 102.

[95] *Id.* at 108.

Bradley Co. v. Local 3, IBEW[96] the Court held that a union's combination with business interests in order to violate the antitrust laws could be enjoined only as respect to those prohibited activities. Otherwise the injunction would directly counter to the Norris-LaGuardia Act. According to Justice Douglas, "when we sanction the addition of the penalty of expulsion from union membership, we qualify the *Allen Bradley* decision."[97]

In *Burlington Truck Lines, Inc. v. United States*[98] the Court considered the overlapping functions of the Interstate Commerce Commission and the NLRB. Several non-union intrastate motor carriers in Nebraska were involved in a labor dispute with a union. The union tried to put pressure on the intrastate carriers by boycotting the traffic of unionized interstate carriers to and from Nebraska. The intrastate carriers formed a corporation and applied to the ICC for a permit to act as an interstate motor carrier. The ICC granted the authority on the basis that the union boycott had resulted in inadequate service to a large section of the public. The Commission made no findings to justify the choice of this remedy instead of other forms of relief under other sections of the Act. Several interstate carriers sought review on the basis that the new corporation would divert traffic from them. The district court sustained[99] the ICC order as within its scope of authority, although in the interim between the ICC order and the District Court decision Congress had passed the LMRDA[100] which raised serious questions as to the validity of such union-induced boycotts. On appeal to the United States Supreme Court, held, judgment reversed and remanded to set aside the Commission's order, and to remand the case to the ICC for further proceedings. The ICC should be particularly careful in its choice of remedy because of the possible effect of its decision on the functioning of the national labor relations policy.

> The Commission acts in a most delicate area here, because whatever it does affirmatively (whether it grants a certificate or enters a cease-and-desist order) may have important consequences upon

[96] 325 U.S. 797 (1945).
[97] 371 U.S. at 113.
[98] 371 U.S. 156 (1962).
[99] Burlington Truck Lines, Inc. v. ICC, 194 F. Supp. 31 (S.D. Ill. 1961).
[100] Labor Management Reporting and Disclosure Act, 73 Stat. 519 (1959), 29 U.S.C. § 151 (Supp. III, 1962), amending 61 Stat. 136 (1947).

the collective bargaining processes between the union and the employer. The policies of the Interstate Commerce Act and the labor act necessarily must be accommodated, one to the other.[101]

VI. Unfair Labor Practices

As usual the Court was called upon to construe the unfair labor practice provisions of the Act to novel or unique situations.

A. Super-seniority to Strike Replacements

The National Labor Relations Act specifically provides that employees have a right to strike. Section 7 states in part, "Employees shall have the right... to engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection."[102] Strikes are among the concerted activities protected for employees by the section. Section 13 provides, "nothing in this Act, except as specifically provided for herein, shall be construed so as either to interfere with or impede or diminish in any way the right to strike, or to affect the limitations or qualifications on that right."[103]

The strike is a legitimate economic weapon when used within the limitations and qualifications prescribed in the NLRA. Section 2(3)[104] of the Act protects the strikers, preserving their status as employees while they are striking for economic reasons and providing that they may not be discharged. But as a protection for the employer the Court decided in 1938 in *NLRB v. Mackay Radio & Tel. Co.*[105] that an employer may hire replacements during an economic strike in order to continue his business, and he need not, at the end of the strike, discharge the replacements to reinstate the returning strikers. During this term the Court was called upon to determine whether the right of replacement in *Mackay* carries with it a right to adopt a super-seniority policy that would assure the replacements some form of tenure.

---

[101] 371 U.S. at 172.

[102] National Labor Relations Act § 7, as amended, 61 Stat. 140 (1947), 29 U.S.C. § 157 (1958).

[103] National Labor Relations Act § 13, as amended, 61 Stat. 151 (1947), 29 U.S.C. § 163 (1958).

[104] National Labor Relations Act § 2(3), as amended, 61 Stat. 137 (1947), 29 U.S.C. § 152(3) (1958).

[105] 304 U.S. 333 (1938).

In *NLRB v. Erie Resistor Corp.*,[106] Local 613 of the International Union of Electrical, Radio and Machine Workers struck in support of new contract demands after the expiration of the old contract. All 478 unit employees participated in the strike. The company continued minor production by the use of clerks, engineers and non-unit personnel. The employer began hiring permanent replacements for the strikers after a month had passed, assuring the replacements they would be retained after the strike ended. The company notified the union that it intended to give the replacements some form of super-seniority. It then announced that replacements and strikers who returned to work would be given twenty years additional seniority for layoff purposes. Within two weeks the number of strikers returning to work caused the union to give up the strike. With the strike ended, the company reinstated all the strikers whose jobs had not been filled. But layoffs soon followed and the employees laid off were largely reinstated strikers whose seniority could not match the super-seniority granted to others. The NLRB determined that a super-seniority offer to strike replacements and to economic strikers who abandon the strike was discriminatory and destructive of the strike.[107] The Court of Appeals reversed[108] on the basis that the right of an employer to replace economic strikers carries with it the right to adopt a seniority policy, provided that the policy is adopted solely to protect and continue the business.

On appeal the Supreme Court reversed the Court of Appeals and affirmed the NLRB decision, holding that an employer's grant of super-seniority to replacements for economic strikers and to employees who abandon the strike is so inherently discriminatory and destructive of union activity as to violate the Taft-Hartley Act without regard to the employer's motivation.

The Court pronounced that "super-seniority by its very terms operates to discriminate between strikers and nonstrikers, both during and after a strike, and its destructive impact upon the strike and union activity cannot be doubted."[109] In reaching this decision the Court affirmed the Board's finding that super-seniority has the following effects and characteristics:

---

[106] 373 U.S. 221 (1962).

[107] Erie Resistor Corp. v. International Union of Elec. Workers, 132 NLRB 621 (1961).

[108] Erie Resistor Corp. v. NLRB, 303 F.2d 359 (3d Cir. 1962).

[109] 373 U.S. at 231.

(1) it affects the tenure of all strikers, whereas permanent replacement affects only those who actually are replaced;
(2) it necessarily operates to the detriment of those who participated in the strike as compared with nonstrikers;
(3) if made available to bargaining-unit employees, as well as new employees, it offers individual benefits to the strikers to induce them to abandon the strike, thus dealing a crippling blow to the strike efforts;
(4) it renders future bargaining difficult, if not impossible, for the collective bargaining representative;
(5) it is in effect offering individual benefits to the strikers to abandon the strike.[110]

The business purpose the employer seeks to serve in ending the strike is outweighed, in the view of the Supreme Court and the Board, by the harmful effects a policy of super-seniority has on union rights. "Under § 8(a)(3) it is unlawful for an employer by discrimination in terms of employment to discourage membership in any labor organization, which includes discouraging participation in concerted activities such as a legitimate strike."[111] Thus, a grant of super-seniority during a strike is violative of section 8(a)(3) without regard to the motivation of the employer.

B. Refusal to Bargain About Agency Shop

In *NLRB v. General Motors Corp.*,[112] discussed earlier, the Court determined that an employer's refusal to bargain with a certified union over the union's proposal for the adoption of an agency shop is an unfair labor practice.

Section 8(a)(5) of the Taft-Hartley Act[113] makes it illegal for an employer to refuse to bargain in good faith about wages, hours, and other conditions of employment with the representative selected by a majority of the employees in a unit appropriate for collective bargaining. However, the employer is not required to bargain over a proposal that he commit an unfair labor practice.

In the instant case, General Motors refused to bargain over the agency shop proposal on the grounds that the agency shop was an

[110] *Id.* at 230.
[111] *Id.* at 233.
[112] 373 U.S. 734 (1963). See also note 38 *supra* and accompanying text.
[113] National Labor Relations Act § 8(a)(5), as amended, 61 Stat. 140 (1947), 29 U.S.C. § 158(a)(5) (1958).

unfair labor practice within section 8(a)(3) of the Act. The Court decided that an agency shop was a lawful subject of bargaining, and therefore General Motors committed an unfair labor practice in refusing to bargain over the proposal.

VII. Railway Labor Act

The policy of collective bargaining by employees through representatives of their own choosing received its initial peacetime Congressional encouragement in the Railway Labor Act in 1926.[114] The Act encouraged the making of agreements relating to all working conditions for railroad employees, and recognized that both the carriers and their employees have the right to choose their own bargaining representatives.[115] A board of mediation was established to facilitate settlement of disputes between the representatives.[116]

The success of the Act led the movement toward the adoption of federal labor legislation for all industry affecting interstate commerce. Because of its special problems, however, the Railway Labor Act has remained separate from the general labor acts. During the past term the Court heard two Railway Labor Act cases which were of particular import to the entire labor field.[117]

[114] Railway Labor Act, 44 Stat. 577 (1926) (now 45 U.S.C. § 151 (1958)).

[115] Railway Labor Act § 2, 44 Stat. 577 (1926) (now 45 U.S.C. § 152 (1958)).

[116] Railway Labor Act § 4, 44 Stat. 579 (1926) (now 45 U.S.C. § 155 (1958)).

[117] The Court also heard two labor cases which involved the application of specialized sections of the Railway Labor Act. In Brotherhood of Locomotive Eng'r v. Louisville & N.R.R., 373 U.S. 33 (1963), the Court held that an employee's right under the Railway Labor Act to bring a federal district court suit for enforcement of a National Railroad Adjustment Board's "time lost" award deprived his union of the right to strike to compel payment of the award by the employer. The Court found that the Act provided a mandatory and exclusive procedure which does not permit either party to resort to economic self-help at any stage.

In International Ass'n of Machinists v. Central Airlines, 372 U.S. 682 (1962), the Court ruled that federal district courts have jurisdiction over a non-diversity suit brought by an airline union to enforce an arbitration award of an airline system board of adjustment created pursuant to the Railway Labor Act by the union and the airline. The Court held that such a suit is a suit arising under the laws of the United States (28 U.S.C. §§ 1331, 1337) (1958), so as to give jurisdiction to federal courts. Section 204 of the Railway Labor Act, which requires carriers and unions to establish system boards of adjustment, makes contracts providing for such adjustment boards federal contracts that are governed and enforced by federal law in federal courts.

A. Work Rules Dispute

The Court sent the long-standing work-rules dispute between the railroads and the operating brotherhoods back to the bargaining tables in *Brotherhood of Locomotive Eng'r v. Baltimore & O.R.R.*[118] This dispute was formally initiated on November 2, 1959, when the railroads served on the brotherhoods notices of intended changes in work-rules, rates of pay, and working conditions in order to eliminate alleged featherbedding and anti-productivity factors. The dispute raged on without success through National Conferences, a Presidential Railroad Commission, and the National Mediation Board. Finally, after the union refused to arbitrate under the Railway Labor Act, the railroads put into effect their rules changes. The union sought an injunction against the change, but it was denied in the district court[119] and in the court of appeals.[120] The Supreme Court affirmed, holding that both parties have exhausted all the statutory procedures, and are relegated to self-help in the adjusting of the dispute, subject only to the invocation of the President's power to appoint an emergency board to avert a threatened strike.[121]

The decision, despite the headlines it created, seems significant only as a minor victory for the right of management to exercise its own prerogatives in dispute areas when resort to bargaining fails and the procedural requirements of the Act are exhausted.

B. Union Political Contributions

In *Brotherhood of Ry. Clerks v. Allen*[122] the Court was called upon to construe a North Carolina decision in the light of the recent *International Ass'n of Machinists v. Street*[123] decision. The North Carolina Supreme Court had affirmed,[124] by an equal division of the

[118] 372 U.S. 284 (1963).

[119] Unreported decision.

[120] Brotherhood of Locomotive Eng'r v. Baltimore & O.R.R., 310 F.2d 503 (7th Cir. 1962).

[121] Railway Labor Act § 10, as amended, 48 Stat. 1197 (1934), 45 U.S.C. § 160 (1958): "If a dispute between a carrier and its employees be not adjusted under the foregoing provisions of this chapter, and should, in the judgment of the Mediation Board, threaten substantially to interrupt interstate commerce to a degree such as to deprive any section of the country of essential transportation service, the Mediation Board shall notify the President, who may thereupon in his discretion, create a board to investigate and report respecting such a dispute."

[122] 373 U.S. 113 (1963).

[123] 367 U.S. 740 (1961).

[124] Allen v. Brotherhood of Ry. Clerks, 256 N.C. 700, 124 S.E.2d 871 (1962).

court, a Superior Court injunction relieving dissenting employees of all obligations to pay union dues exacted under union-shop contracts where the union used part of the dues for political purposes to which the employees objected.

The Supreme Court reversed. It announced that according to *Street* a union has no power to use an employee's dues, over his objections, to support political causes which he opposes. But the injunction here was found improper in relieving the employees of all obligations to pay the moneys due under the contract. The injunction "sweeps too broadly . . . and might well interfere with the union's performance of those functions and duties which the Railway Labor Act places upon them to attain its goal of stability in the industry."[125]

In compliance with the *Street* rule, the Court remanded the case for the determination of the following factors: (1) What expenditures disclosed by the record are political? (2) What percentage of total union expenditures are political expenditures?[126]

The objecting employee is entitled to restitution of the moneys "exacted from him as is the proportion of the union's total expenditures made for such political activities to the union's total budget. . . ."[127] In determining such proportion, the Court determined that "basic considerations of fairness" compel that the union bear the burden of proof since they possess the facts and records from which it may be calculated.[128]

The Court thought it "appropriate to suggest, in addition, a practical decree to which each respondent proving his right to relief would be entitled. Such a decree would order (1) [a proportionate refund] . . . and (2) a reduction of future such exactions from him by the same proportion."[129] But the Court, recognizing that such proportions may in actuality vary from time to time, encouraged unions to

> consider the adoption . . . of some voluntary plan by which dissenters would be afforded an internal union remedy. . . . if a union agreed upon a formula for ascertaining the proportion of political expenditures in its budget, and made available a simple

[125] 373 U.S. at 120.
[126] 373 U.S. at 121.
[127] *Ibid.*
[128] *Id.* at 122.
[129] *Ibid.*

> procedure for allowing dissenters to be excused from having to pay this proportion of money due from them under the union-shop agreement, prolonged and expensive litigation might well be averted.[130]

The Court then suggested that precedent for such a plan exists in the Trade Union Act of 1913.[131]

This decision permits the union to eliminate the so-called "free rider," *i.e.*, it permits the union by agreement with the employer to require all employees to join the union and pay dues as a condition of continued employment; but the decision prevents the union from using these exacted funds for "political" purposes when the dues payer objects.

VIII. Conclusion

The problems arising from automation, increasing unemployment and new legislation have made the law of labor-management relations increasingly complex. During the past term the Court took the opportunity to reduce some of this complexity by handing down clear and concise guidelines in the areas of decision and by placing more emphasis on the rulings of the National Labor Relations Board.[132] The continuation of such a policy by the Court will necessarily eventuate in a predictable and more uniform application of the Taft-Hartley Act to labor-management relations.

Wayne S. Bishop

---

[130] *Id.* at 122-23.

[131] *Id.* at 123, n.8.

[132] It is pertinent to illustrate the agreement between the Court and the Labor Board during the term. The Court heard five cases on appeal from the Board, and affirmed four of these. See 32 U.S.L. Week 3037 (U.S. July 16, 1963). This becomes significant when the entire record of the Kennedy Labor Board is compared with the record of the Eisenhower Board before practically the same Court. In the 1961-1962 term the Court affirmed all eight decisions from the first Kennedy Board. See 26 NLRB Ann. Rep. 21 (1962). During 1960-1961, the Court reviewed ten decisions from the Eisenhower Board, affirming only two and modifying one. See 25 NLRB Ann. Rep. 19 (1961). In the 1959-1960 term, the Court reviewed six Eisenhower Board decisions, affirming one and modifying one. See 24 NLRB Ann. Rep. 14 (1960). The record of the Kennedy Board indicates that there is finally a mutual understanding in the application of the federal labor policy between the Board and the Supreme Court.

Conflict of Laws—Most Significant Relationship Rule

Tort choice of law problems are traditionally resolved by reference to the *lex loci delicti*—law of the place of the wrong.[1] The place of the wrong is generally considered to be "the state where the last event necessary to make an actor liable for an alleged tort takes place."[2] The rule is a product of analytical jurisprudence[3] and is predicated on the notion that since the plaintiff sues to enforce a right resulting from his injury, the law of the state in which the injury occurred should govern the existence of the right and the extent of its vindication.[4] The rule has subsisted in this country amid both praise and criticism. In recent years, its simple virtues of certainty, ease of application, and predictability, though not totally ignored,[5] have been submerged in waves of criticism directed at the unjust results which frequently ensue from its application.[6] Indeed, its arbitrary character and disregard for governmental interests involved in the situations it governs have provoked some courts to dodge the rule,[7] and others to abandon it.[8] Recent criticism has de-

[1] See, *e.g.* Howard v. Howard, 200 N.C. 574, 158 S.E. 101 (1931); RESTATEMENT, CONFLICT OF LAWS § 378 (1934). See generally 2 BEALE, THE CONFLICT OF LAWS § 378.2 (1935); GOODRICH, CONFLICT OF LAWS § 92 (1949).

[2] Thus, where the plaintiff in Arkansas is injured by a rock blasted from a quarry in some other state, the law of Arkansas will govern the substantive rights and liabilities of the parties. Cameron v. Vandergriff, 53 Ark. 381, 13 S.W. 1092 (1890). *Accord,* RESTATEMENT, CONFLICT OF LAWS § 377 (1934). See generally 2 BEALE, *op. cit. supra* note 1, § 378.2; GOODRICH, *op. cit. supra* note 1, § 93.

[3] RESTATEMENT (SECOND), CONFLICT OF LAWS, Introductory Note, Topic 1 (Tent. Draft No. 8, 1963).

[4] Slater v. Mexican Nat'l R.R., 194 U.S. 120 (1904); Loucks v. Standard Oil Co. of New York, 224 N.Y. 99, 120 N.E. 198 (1918). See generally GOODRICH, *op. cit. supra* note 1, § 93.

[5] 25 ALBANY L. REV. 313, 317 (1961); Comment, 61 COLUM. L. REV. 1497, 1509, 1511 (1961); Note, 36 N.Y.U.L. REV. 723, 727, 729-30 (1961); 12 SYRACUSE L. REV. 395, 397 (1961); Comment, 15 RUTGERS L. REV. 620, 624 (1961).

[6] Cavers, *A Critique of the Choice-of-Law Problem,* 47 HARV. L. REV. 173 (1933); Cook, *Tort Liability and the Conflict of Laws,* 35 COLUM. L. REV. 202 (1935); Cook, *The Logical and Legal Bases of the Conflict of Laws,* 33 YALE L.J. 457 (1923); Currie, *Conflict, Crisis, and Confusion in New York,* 1963 DUKE L.J. 1 (1963); Morris, *The Proper Law of a Tort,* 64 HARV. L. REV. 881 (1951); Rheinstein, *The Place of Wrong: A Study in the Method of Case Law,* 19 TUL. L. REV. 4 (1944).

[7] *E.g.,* Kilberg v. Northeast Airlines, Inc., 9 N.Y.2d 34, 172 N.E.2d 526, 211 N.Y.S.2d 133 (1961), where the New York Court of Appeals, as an

veloped the thought that perhaps a more flexible approach would serve the ends of justice to a greater degree than the wholly mechanical approach, traditionally employed by most courts.[9]

One of the more significant areas of criticism directed at the *lex loci delicti* approach involves its application to so-called multi-state torts—situations in which the alleged tortious conduct and consequent injury occur in different jurisdictions.[10] In *Lowe's North Wilkesboro Hardware, Inc. v. Fidelity Mut. Life Ins. Co.*,[11] the Fourth Circuit Court of Appeals, interpreting the North Carolina

---

alternative ground for decision, classified as a procedural matter the limitation of damages recoverable in an action arising out of the wrongful death of a New York citizen in Massachusetts, thus permitting the application of the law of the forum rather than that of the place of the wrong. Though the New York court has subsequently retreated from this position, Davenport v. Webb, 11 N.Y.2d 392, 183 N.E.2d 902, 230 N.Y.S.2d 17 (1962), the constitutionality of the New York court's refusal on other grounds to apply the law of the place of the wrong has been upheld. Pearson v. Northeast Airlines, Inc., 309 F.2d 553 (2d Cir. 1962) (rehearing in banc), *reversing* 307 F.2d 131 (2d Cir. 1962), *cert. denied* 372 U.S. 912 (1963). *Cf.* Richards v. United States, 369 U.S. 1 (1962).

[8] Bowles v. Zimmer Mfg. Co., 277 F.2d 868 (7th Cir. 1960); Emery v. Emery, 45 Cal. 2d 421, 289 P.2d 218 (1955); Grant v. McAuliffe, 41 Cal. 2d 859, 264 P.2d 944 (1953); Schmidt v. Driscoll Hotel, Inc., 249 Minn. 376, 82 N.W.2d 365 (1957); Thompson v. Thompson, 193 A.2d 439 (N.H. 1963); Babcock v. Jackson, 12 N.Y.2d 473, 191 N.E.2d 279, 240 N.Y.S.2d 743 (1963); Haumschild v. Continental Casualty Co., 7 Wisc. 2d 130, 95 N.W.2d 814 (1959). *Cf.* Richards v. United States, 369 U.S. 1 (1962); Vrooman v. Beech Aircraft Corp., 183 F.2d 479 (10th Cir. 1950); Levy v. Daniels U-Drive Auto Renting Co., 108 Conn. 333, 143 Atl. 163 (1928).

[9] The American Law Institute is presently considering a modification of the rigid rule embodied in the original Restatement in favor of a more flexible rule which provides that "The local law of the state which has the most significant relationship with the occurrence and with the parties determines their rights and liabilities in tort." RESTATEMENT (SECOND), CONFLICT OF LAWS § 379 (Tent. Draft No. 8, 1963). It is interesting to note that the Institute considers the state in which the injury occurs to have the most significant relationship in the majority of tort situations. RESTATEMENT (SECOND), CONFLICT OF LAWS § 379, comment *b* at 4 (Tent. Draft No. 8, 1963).

[10] Assume that under the law of State *X*, an actor is liable for damage willfully or negligently caused by fire, whereas under the law of State *Y*, an actor is absolutely liable for any damage caused by fire. *D* starts a fire in State *X* which spreads and damages the property of *P* located in State *Y*. Assume that *D* neither willfully nor negligently caused the damage. A court sitting in State *Z*, following the *lex loci delicti* approach, will apply the law of State *Y* in determining whether *D* must compensate *P* for his loss. Thus, whereas *D* was completely in compliance with the law of the state in which he acted, he will nevertheless have to respond in damages. The result is criticized in Cook, *Tort Liability and The Conflict of Laws*, 35 COLUM. L. REV. 202, 207 (1935).

[11] 319 F.2d 469 (4th Cir. 1963).

choice of law rule,[12] held that the existence of a cause of action resulting from defendant's alleged negligent conduct in Pennsylvania and plaintiff's consequent injury in North Carolina would be determined by reference to the law of that state having the most significant relationships with the events constituting the alleged tort and with the parties. Plaintiff, a North Carolina corporation, pursuant to loan negotiations with a third party, applied to defendant, a Pennsylvania insurance company, for a 200,000 dollar policy insuring the life of its president. The results of medical examinations conducted in North Carolina, together with other application forms filled out in North Carolina, were mailed to defendant and received at its home office in Pennsylvania by October 14, 1960. On October 20, 1960, plaintiff was notified that defendant had declined to issue a 200,000 dollar policy, but would issue a 50,000 dollar policy instead. Plaintiff accepted the offer of a 50,000 dollar policy, at the same time requesting defendant to endeavor to increase the amount of coverage on the policy. Two days later, plaintiff's president died in North Carolina. Plaintiff instituted suit in the Middle District Court of North Carolina to recover 200,000 dollars for defendant's alleged negligent delay in acting upon plaintiff's application for insurance. It was conceded in the District Court that such a cause of action was recognized in North Carolina,[13] but not in Pennsylvania.[14] The District Court concluded

[12] A federal court in a diversity suit must follow the substantive law of the state in which it sits. Erie R. Co. v. Tompkins, 304 U.S. 64 (1937). A state's conflict of laws rules are considered a part of its substantive law for this purpose. Klaxon Co. v. Stentor Elec. Mfg. Co., 313 U.S. 487 (1941).

[13] In Fox v. Volunteer State Life Ins. Co., 185 N.C. 121, 116 S.E. 266 (1923), *appealed on other grounds* 186 N.C. 763, 119 S.E. 172 (1923), a cause of action was recognized for negligent failure of an insurance agent to deliver the policy to the applicant once the application had been accepted. In the *Fox* case, the Court hinted that an action might be maintained for negligent delay in acting upon the application itself. *Id.* at 124, 116 S.E. at 268 (dictum). This dictum was reiterated in Rocky Mount Sav. & Trust Co. v. Aetna Life Ins. Co., 201 N.C. 552, 554-55, 160 S.E. 831, 832 (1931) (dictum); *cf.* Bryant v. Occidental Life Ins. Co., 253 N.C. 565, 117 S.E.2d 435 (1960). There has never been a direct holding in North Carolina that a cause of action may be maintained for negligent delay in acting upon an application for life insurance. Indeed, a recent case casts doubt on the continued vitality of the *Fox* doctrine that an action may be maintained for the agent's failure to deliver the policy within a reasonable time after its issuance. Blackman v. Liberty Life Ins. Co., 256 N.C. 261, 123 S.E.2d 467 (1962). For a brief discussion of this case, see *Torts, Tenth Annual Case Law Survey,* 41 N.C.L. REV. 512, 518 (1963). Thus, it is debatable whether North Carolina recognizes a cause of action for negligent delay in acting

that under the North Carolina choice of law rule, the situation would be governed by the law of the place of the tort. Applying this standard, it was reasoned that since the alleged negligence occurred in Pennsylvania, Pennsylvania was the place of the tort. Accordingly, defendant's motion for summary judgment was granted.[15]

The Court of Appeals conceded that the North Carolina Supreme Court had invariably followed the traditional *lex loci delicti* approach in resolving tort choice of law problems in which both conduct and injury occurred in the same jurisdiction.[16] However, since the multi-state aspect of the principal case presented considerations not present in cases where both conduct and injury occur in one state,[17] prior decisions in cases of the latter type were thought not to be controlling here. Unable to determine from prior decisions the rule which the North Carolina Supreme Court would probably apply if confronted with the multi-state problem,[18] the Court of Ap-

upon an application for insurance. See generally Annot., 32 A.L.R.2d 487, 511 (1953).

[14] Zayc v. John Hancock Mut. Life Ins. Co., 338 Pa. 426, 13 A.2d 34 (1940). *Accord,* Shipley v. Ohio Nat'l Life Ins. Co., 199 F.Supp. 782 (W.D. Pa. 1961), *aff'd,* 296 F.2d 728 (3rd Cir. 1961).

[15] Lowe's North Wilkesboro Hardware, Inc. v. Fidelity Mut. Life Ins. Co., 206 F. Supp. 427, 430 (M.D.N.C. 1962).

[16] Shaw v. Lee, 258 N.C. 609, 129 S.E.2d 288 (1963), 41 N.C.L. REV. 843; Doss v. Sewell, 257 N.C. 404, 125 S.E.2d 899 (1962); Kizer v. Bowman, 256 N.C. 565, 124 S.E.2d 543 (1962); Knight v. Associated Transp., Inc., 255 N.C. 462, 122 S.E.2d 64 (1961); Nix v. English, 254 N.C. 414, 119 S.E.2d 220 (1961); McCombs v. McLean Trucking Co., 252 N.C. 699, 114 S.E.2d 683 (1960); Howle v. Twin States Express, Inc., 237 N.C. 667, 75 S.E.2d 732 (1953); Childress v. Johnson Motor Lines, 235 N.C. 522, 70 S.E.2d 558 (1952); Hill v. Carolina Freight Carriers Corp., 235 N.C. 705, 71 S.E.2d 133 (1952); Jones v. Otis Elevator Co., 234 N.C. 512, 67 S.E.2d 492 (1951); Jones v. Otis Elevator Co., 231 N.C. 285, 56 S.E.2d 684 (1949); Morse v. Walker, 229 N.C. 778, 51 S.E.2d 496 (1949); Harper v. Harper, 225 N.C. 260, 34 S.E.2d 185 (1945); Charnock v. Taylor, 223 N.C. 360, 26 S.E.2d 911 (1943); Baird v. Baird, 223 N.C. 730, 28 S.E.2d 225 (1943); Russ v. Atlantic Coast Line R.R., 220 N.C. 715, 18 S.E.2d 130 (1942); Hale v. Hale, 219 N.C. 191, 13 S.E.2d 221 (1941); Farfour v. Fahad, 214 N.C. 281, 199 S.E. 521 (1938); Rodwell v. Camel City Coach Co., 205 N.C. 292, 171 S.E. 100 (1933); Wise v. Hollowell, 205 N.C. 286, 171 S.E. 82 (1933); Howard v. Howard, 200 N.C. 574, 158 S.E. 101 (1931); Harrison v. Atlantic Coast Line R.R., 168 N.C. 382, 84 S.E. 519 (1915); Harrill v. South Carolina & Georgia Extension Ry., 132 N.C. 655, 44 S.E. 109 (1903).

[17] The *lex loci delicti* approach is generally followed indiscriminately both in situations where the conduct and injury occur in the same state and in those cases involving conduct in one state and injury in another. See note 2 *supra*; RESTATEMENT, CONFLICT OF LAWS § 377 (1934).

[18] There is at least one North Carolina case and language in other North Carolina cases from which it might be concluded that the North Carolina

peals rejected the *lex loci delicti* approach, and adopted the more flexible rule. The relationship of Pennsylvania with the events and the parties was determined to be more significant than that of North Carolina, and hence the District Court's granting of summary judgment for defendant was affirmed.[19]

Though the rule adopted by the Court of Appeals appears meritorious in abstract form,[20] its application in the principal case is con-

Supreme Court would not abandon the *lex loci delicti* approach if confronted with the facts of the principal case. One of the areas in which great strides have been made away from the *lex loci delicti* approach is the area of interspousal immunity from tort liability. Several courts have departed from *lex loci delicti* in this area on the premise that the domicile of the spouses has a greater governmental interest in this question, regardless of where the conduct and injury occur. Emery v. Emery, 45 Cal. 2d 421, 289 P.2d 218 (1955); Thompson v. Thompson, 193 A.2d 439 (N.H. 1963); Haumschild v. Continental Casualty Co., 7 Wisc. 2d 130, 95 N.W.2d 814 (1959). As recently as February 1, 1963, the North Carolina Supreme Court was urged to overrule Howard v. Howard, 200 N.C. 574, 158 S.E. 101 (1931), where it was held that the capacity of a wife to sue her husband for injuries sustained in New Jersey would be dependent on the law of New Jersey, the state in which the injuries were sustained. In Shaw v. Lee, 258 N.C. 609, 129 S.E.2d 288 (1963), 41 N.C.L. REV. 843, the court, confronted with the above cited cases, refused to overrule the *Howard* case. In so doing, the Court's adherence to *lex loci delicti* and the theory underlying the rule was reaffirmed. In view of the *Shaw* decision, coupled with the fact that the area in which it operates is fertile ground for conflict of laws revolution, it is indeed doubtful that the North Carolina Supreme Court would abandon *lex loci delicti* if confronted with the facts of the principal case. See also Harper v. Harper, 225 N.C. 260, 262, 34 S.E.2d 185, 187 (1945), where it is stated: "The actionable quality of the defendant's conduct in inflicting injury upon the plaintiff must be determined by the law of the place where the *injury* was done." (Emphasis added.) *Cf.* Charnock v. Taylor, 223 N.C. 360, 362, 26 S.E.2d 911, 913 (1943), where the Restatement version of *lex loci delicti* is quoted with approval.

[19] Two cases have split on the same factual situation. Killpack v. National Old Line Ins. Co., 229 F.2d 851 (10th Cir. 1956) (applying the law of the state in which the insurer's home office was located); Mann v. Policyholders' Nat'l Life Ins. Co., 78 N.D. 724, 51 N.W.2d 853 (1952) (applying the law of the plaintiff's domicile).

The outcome of the litigation is somewhat ironic from the plaintiff's point of view. The plaintiff argued in the District Court that the *lex loci delicti* approach should be abandoned and the law of the state with the most significant relationships applied. The District Court did not agree, and applying the *lex loci delicti* approach, held Pennsylvania to be the place of the wrong. It seems that a good argument could have been made that plaintiff sustained its injury in North Carolina, thus requiring application of North Carolina law under *lex loci delicti.* Finally, the plaintiff persuaded the Court of Appeals to abandon *lex loci delicti,* only to have Pennsylvania selected as the state with the more significant relationships.

[20] It is not the purpose of this note to compare the merits and demerits of the *lex loci delicti* rule and the rule adopted in the principal case. They are thoroughly expounded in the articles cited in notes 5 & 6 *supra.*

fusing and productive of few, if any, guidelines to assist the practicing attorney in evaluation of future fact situations.[21] Particularly perplexing is the disposition of the various factors urged in support of the plaintiff's contention that North Carolina law should have been applied. The plaintiff advanced in its favor the fact that it was domiciled and engaged in business in North Carolina, the fact that its president whose life was sought to be insured lived and died in North Carolina, and the fact that the injury, an indispensable element of the tort, occurred in North Carolina. Instead of analyzing these factors with the view of determining whether they tended to give North Carolina a more significant relationship with the events and the parties, the Court of Appeals seemed more concerned with whether these factors warranted the conclusion that the tort complained of happened in North Carolina. Granted, the fact that the tort happened in a particular state might be critical in evaluating whether that state has a more significant relationship with the events and the parties than some other state. Nevertheless, the mere statement that the factors urged by the plaintiff would not support a conclusion that the tort happened in North Carolina hardly seems dispositive of whether or not these same factors are sufficient to give North Carolina a more significant relationship with the events and the parties than Pennsylvania.[22]

Four factors were enumerated as justifying the conclusion that Pennsylvania had a more significant relationship with the events and the parties than North Carolina: the application was sent to the home office in Pennsylvania; all information relative to the policy was obtained through or sent to the Pennsylvania office; an application for a policy of that size could only be acted upon at the Pennsylvania office; it was in Pennsylvania that the application was finally acted upon. In short, the events leading up to and constituting the alleged delay were determined by the Court of Appeals to be

[21] The sole guideline furnished by the Court of Appeals is this statement: "The relative weight due particular factors will vary from case to case, and the court must judge the totality of contacts of the states concerned with the parties and the subject matter." 319 F.2d at 473.

[22] The most favorable interpretation of the court of appeals' treatment is that these factors would not justify the conclusion that the *injury* occurred in North Carolina. It would seem that the plaintiff was deprived in North Wilkesboro, North Carolina, of the opportunity to obtain insurance on the life of its president. If the *injury* occurred elsewhere, then where, and why are that state's contacts not considered?

the critical factors, and the mere fact of their physical occurrence in Pennsylvania warranted the conclusion that Pennsylvania's relationship was the more significant.

Pennsylvania's selection in the principal case as the state with the more significant relationship seems to be based solely on that state's preponderance of physical contacts with the events and the parties. The opinion is totally lacking in analysis of these physical contacts in the light of possible governmental interests involved. In vivid contrast is the New York Court of Appeals' treatment in *Babcock v. Jackson.*[23] In the *Babcock* case, plaintiff and defendant, both New York residents, had embarked upon a weekend trip to Canada in defendant's automobile. While driving in the Province of Ontario, a collision, allegedly caused by defendant's negligence, resulted in injury to the plaintiff. Defendant, assuming that Ontario law applied since both conduct and injury occurred in that province, interposed the Ontario guest statute in bar of plaintiff's suit brought in New York.[24] The New York Supreme Court agreed with defendant's position and dismissed the action, the Appellate Division affirming. The Court of Appeals, applying a choice of law rule similar to that adopted in the principal case, reversed. The New York Court of Appeals initially outlined the relative physical contacts of both New York and Ontario, emphasizing that analysis of the contacts could only be made in light of the ultimate issue to be decided—whether a guest passenger may sue his host for injuries sus-

[23] 12 N.Y.2d 473, 191 N.E.2d 279, 240 N.Y.S.2d 743 (1963). The New York Court of Appeals has pioneered the revolution in the field of conflict of laws. Kilberg v. Northeast Airlines, Inc., 9 N.Y.2d 34, 172 N.E.2d 526, 211 N.Y.S.2d 133 (1961) (refusing to apply the law of the place of the wrong with respect to the limitation of damages recoverable by reason of the wrongful death in Massachusetts of a New York citizen); Auten v. Auten, 308 N.Y. 155, 124 N.E.2d 99 (1954) (abandoning the traditional rule that the law of the place where a contract is made controls all issues as to its execution, interpretation or validity, whereas the law of the place of performance controls matters connected with performance). See also Haag v. Barnes, 9 N.Y.2d 554, 559-60, 175 N.E.2d 441, 444, 216 N.Y.S.2d 65, 68-69 (1961). See generally Currie, *Conflict, Crisis, and Confusion in New York,* 1963 DUKE L.J. 1 (1963).

[24] The Ontario guest statute, ONT. REV. STAT. c. 172, § 105(2) (1960), instead of requiring proof of gross negligence which is required by most American guest statutes, flatly precluded recovery by a guest under any conditions. The New York Court of Appeals was apparently influenced by the fact that the Ontario statute was without parallel in the United States. See Babcock v. Jackson, 12 N.Y.2d 473, n.13, 191 N.E.2d 279, 285 & n.13, 240 N.Y.S.2d 743, 751 & n.13 (1963).

tained during the guest-host relationship.[25] New York's contacts were said to stem from a guest-host relationship between New York citizens originating and intended to terminate in New York and an accident arising out of the negligent operation of an automobile licensed and undoubtedly insured in New York. On the other hand, Ontario's sole contact with the situation was the fact that the accident occurred there. The public policies of both New York and Ontario were then weighed vis-à-vis the issue involved. It was emphasized that the New York legislature had repeatedly refused to enact legislation limiting the right of a guest to recover for injuries inflicted by his host. This refusal was deemed to evidence a policy of compensation in such cases, and no reason could be found to limit the implementation of this policy to accidents occurring within the borders of New York. On the other hand, Ontario's policy as reflected in its guest statute was the prevention of fraudulent claims by passengers, in collusion with their drivers, against insurance companies. This policy was thought to be directed at such claims asserted against Ontario defendants and their insurance carriers. Reasoning from this, it was determined that Ontario could have no valid legislative interest in whether fraudulent claims were asserted by New York plaintiffs against New York defendants and their insurance carriers. Thus, having determined that New York had a greater governmental interest in the subject matter of the litigation, the Court of Appeals applied New York law in resolution of the dispute.

The difference in the approach taken by the *Babcock* court and that followed in the principal case is readily apparent. *Lowe's* seems to reflect the view that the relationship of the state having the greater total of physical contacts with the events and the parties would, a fortiori, be more significant than that of the other state. On the other hand, the *Babcock* court reached its decision by determining which government, because of its physical contacts, had a greater governmental interest in the subject matter of the litigation. This was accomplished by initially investigating the policies of each government as expressed in the conflicting laws, and then weighing the

[25] It was pointed out that different considerations would be involved "had the issue related to the manner in which the defendant had been driving his car at the time of the accident." *Id.* at —, 191 N.E.2d at 284, 240 N.Y.S.2d at 750-51.

interest of each in the vindication of its policy in the light of the physical contacts with the events and the parties. Concededly, in the absence of conflicting statutory pronouncement on the substantive issue in litigation, the facts of the principal case do not lend themselves as readily to such a governmental-interest analysis as did the facts of the *Babcock* case. Nevertheless, the degree of significance to be attached to each state's physical contacts might be assessed by comparing policies reflected in general laws relative to dealings between insurance companies and individuals, with a view toward determining whether either state, because of its physical contacts, would have a greater interest in the subject matter of the litigation. Investigation might reveal a Pennsylvania policy of protecting insurance companies from claims arising out of preliminary negotiations with applicants for insurance. Such a policy would certainly give Pennsylvania an interest in any dispute arising out of preliminary negotiations between a domiciliary company and an applicant for insurance. On the other hand, investigation might reveal a North Carolina policy designed to protect its citizens in their dealings with foreign insurance companies.[26] Since the plaintiff in the principal case was a North Carolina citizen, the existence of such a policy would also seem to give North Carolina an interest in the litigation. Especially would this be true if the defendant were licensed to do business in North Carolina, in which case North Carolina's interest in the defendant's conduct while dealing with a North Carolina applicant for insurance would seem to be paramount to that of any other state, regardless of where the conduct complained of occurred.

Perhaps, an alternate method might be employed to assess the

[26] Consider the following as possible evidence of such a policy: "All contracts of insurance on property, lives, or interests in this State shall be deemed to be made therein, and all contracts of insurance the applications for which are taken within the State shall be deemed to have been made within this State and are subject to the laws thereof." N.C. GEN. STAT. § 58-28 (1960); "This is true although the insurance company may under its charter be allowed privileges which are contrary to the statutes in this State." Wilson v. Supreme Conclave, 174 N.C. 628, 94 S.E. 443 (1917); "It is unlawful for any company to make any contract of insurance upon or concerning any property or interest or lives in this State, or with any resident thereof, or for any person as insurance agent or *insurance broker* to make, *negotiate, solicit, or in any manner aid in the transaction of such insurance,* unless and except as authorized under the provisions of this chapter." N.C. GEN. STAT. § 58-29 (1960). (Emphasis added.)

significance of each state's physical contacts. This method would entail an examination into the basic purpose of the tort rule involved. If it were determined that the basic purpose of the tort rule is to deter or prevent hazardous conduct, then the state in which the conduct occurred would generally have a greater interest in the application of its law. On the other hand, if the tort rule were primarily designed for the protection of a class of persons as opposed to the prevention of hazardous conduct, then the state in which the injury was suffered would generally have a greater interest in the application of its law. Though this method of evaluating contacts is suggested by the American Law Institute, the Institute is careful to point out that this method ordinarily will be of little assistance, since most tort rules involve elements of both prevention of hazardous conduct and protection of the individual.[27] Nevertheless, this method would seem to be peculiarly adaptable to the facts of the principal case. The disparity of bargaining power existing between individuals and insurance companies has been recognized as justifying both judicial and legislative protection of the individual.[28] Though the rationale employed by those courts which recognize a cause of action for negligent delay in acting upon an application for insurance varies,[29] the motivating factor underlying those decisions is a desire to ameliorate "the insecure fortune of an individual pitted against the security of an actuary table."[30] Since the plaintiff is domiciled in North Carolina, and since the injury complained of presumably occurred there, it would seem reasonable, on this basis, to argue that

[27] RESTATEMENT (SECOND), CONFLICT OF LAWS § 379, comment *c* at 9 (Tent. Draft No. 8, 1963).

[28] See Rocky Mount Sav. & Trust Co. v. Aetna Life Ins. Co., 201 N.C. 552, 160 S.E. 831 (1931).

[29] Duffie v. Bankers' Life Ass'n, 160 Iowa 19, 139 N.W. 1087 (1913) (insurance companies are affected with a public interest); Bekken v. Equitable Life Assur. Soc'y of the United States, 70 N.D. 122, 293 N.W. 200 (1940) (negotiations for insurance are unlike negotiations for other contracts due to disparity of bargaining power); Boyer v. State Farmers' Mut. Hail Ins. Co., 86 Kan. 442, 121 Pac. 329 (1912) (Nature of risk against which insurance sought behooves prudent man to act with diligence); Columbian Nat'l Life Ins. Co. v. Lemmons, 96 Okla. 228, 222 Pac. 255 (1923) (implied contract between applicant and insurer that latter will act within a reasonable time); Strand v. Bankers Life Ins. Co., 115 Neb. 357, 213 N.W. 349 (1927) (unreasonable delay may deprive applicant of opportunity to obtain insurance elsewhere).

[30] Rocky Mount Sav. & Trust Co. v. Aetna Life Ins. Co., 201 N.C. 552, 554, 160 S.E. 831, 832 (1931).

North Carolina's interest in the subject matter of litigation is greater than that of Pennsylvania.

Many authorities consider the loss of the advantages inherent in *lex loci delicti* a small price to pay for a conflict of laws rule which would permit greater recognition of governmental interests. It is hoped that if, and when, the North Carolina Supreme Court accedes to this position, the reason for abandonment of the traditional rule will not be ignored in application of the new.

WILLIAM E. SHINN, JR.

Consent Judgment—Reservation of Rights Against Third Party—Release

In a recent North Carolina case,[1] plaintiff passenger brought an action against two defendants as joint tortfeasors for injuries sustained in an automobile collision. While the action was pending the plaintiff entered into a covenant not to sue, consent judgment and satisfaction of that judgment with *A*. Both the covenant not to sue and the consent judgment reserved the rights of the plaintiff against the other defendant, *B*, a corporation. In the pending action *B* pleaded that the transactions constituted a release of one of the two joint tortfeasors and therefore barred further recovery against the defendant corporation. The jury found that the transactions constituted a covenant not to sue and awarded damages. The trial judge set aside the jury's verdict and ordered a new trial at which the transactions were concluded to be a release. The court affirmed this decision stating that the agreement, consent judgment and satisfaction extinguished the cause of action notwithstanding the intention of the parties; therefore, the plaintiff was barred from further recovery. This raises the question of whether a consent judgment should be given the same effect as a judgment after trial or whether a consent judgment should be viewed merely as a contract approved by the court, thereby allowing the court to look behind the agreement and determine whether the intention of the parties has been carried out.

When a person is injured by the negligence of joint tortfeasors, he may elect to sue them either jointly or individually.[2] There has

[1] Simpson v. Plyler, 258 N.C. 390, 128 S.E.2d 843 (1963).
[2] RESTATEMENT, TORTS § 882 (1939).

been some confusion concerning the effect which a judgment against one joint tortfeasor will have on the rights of the other tortfeasors. The early English rule, until changed by statute in 1935,[3] provided that there was only one cause of action in joint torts[4] and that a judgment against one, even though unsatisfied, merged with the single cause of action and was a bar to further action.[5] If the defendants were concurrent tortfeasors,[6] there were multiple causes of action and an unsatisfied judgment against one did not bar recovery against the others.[7] The American courts, due to the code method of pleading,[8] no longer distinguish between joint and concurrent tortfeasors but permit joinder of parties in situations where the independent negligence of both defendants produces a single injury[9] or where defendants were under a common duty.[10] In the absence of a statute to the contrary[11] the rule in this country rejects

[3] Law Reform (Married Women and Tortfeasors) Act, 1935, 25 & 26 Geo. 5, c. 30.

[4] The common law rules as to joinder were restricted to those who acted in concert of action. Where there was concert of action, joinder was permitted but not compulsory, and the defendants could be sued severally for the entire damages. Sir John Heydon's Case, 11 Co. Rep. 5a, 77 Eng. Rep. 1150 (1613); Smithson v. Garth, 3 Lev. 324, 83 Eng. Rep. 711 (1691). See generally PROSSER, TORTS § 46 (2d ed. 1955).

[5] Brinsmead v. Harrison, [1872] L.R.7C.P. 547 (joint detinue); Brown v. Wooten, Cro. Jac. 73, 79 Eng. Rep. 62 (1600) (joint trover); King v. Hoare, 13 M. & W. 494, 153 Eng. Rep. 245 (1838) (joint trespass). See 13 HALSBURY, LAWS OF ENGLAND *Estoppel* § 471 (2d ed. 1934). See generally PROSSER, *op. cit. supra* note 4, at 241.

[6] If the defendants joined separately and independently to cause a single injury, the early English courts would not permit the plaintiff to bring a joint action against both. Sadler v. Great W. Ry., [1896] A.C. 450. See PROSSER, *op. cit. supra* note 4, at 236.

[7] Morris v. Robinson, 3 B. & C. 196, 107 Eng. Rep. 706 (1824).

[8] "[I]n this country..., where the wrongful acts of two or more persons, though independent, were concurrent and resulted in a single injury to the plaintiff, such persons are considered joint tort-feasors for the purpose of suit." CLARK, CODE PLEADING § 60, at 383-84 (2nd ed. 1947).

[9] Way v. Waterloo, Cedar Falls & No. R.R., 239 Iowa 244, 29 N.W.2d 867 (1947); Meyer v. Cincinnati St. Ry., 157 Ohio St. 38, 104 N.E.2d 173 (1952).

[10] Schaffer v. Pennsylvania R.R., 101 F.2d 369 (7th Cir. 1939); Doeg v. Cook, 126 Cal. 213, 58 Pac. 707 (1899); Johnson v. Chapman, 43 W. Va. 639, 28 S.E. 744 (1897).

[11] R. I. GEN. LAWS ch. 6, § 10-6-6 (1956) was construed in Hacket v. Hyson, 72 R.I. 132, 48 A.2d 353 (1946) to reverse the common law notion in America that satisfaction of judgment effected a discharge of all tortfeasors and held that satisfaction is merely applied in reduction of any judgments against the others. *Contra,* McTigue v. Levy, 260 App. Div. 928, 2 N.Y.S.2d 114 (1940) construing N.Y. CIV. PRAC. ACT § 112-a; Sarine v. American Lumberman's Mut. Cas. Co., 258 App. Div. 653, 17 N.Y.S.2d 754 (1940) construing N.Y. CREDITOR & DEBTOR LAW § 232.

the idea that a mere rendition of a judgment against one tortfeasor releases the others and holds that nothing short of satisfaction of the judgment will bar the plaintiff from proceeding further.[12] The plaintiff may recover separate judgments against all the joint tortfeasors, and until he accepts satisfaction the cause of action is not extinguished. If the plaintiff gets only one judgment and accepts satisfaction of that judgment, his cause of action is extinguished and he cannot bring any further action against the other defendants. The theory behind the American rule stems from the common law notion that a person is entitled to but one compensation.[13] Since the plaintiff's cause of action against the joint tortfeasors is single and indivisible, the reducing of his claim to judgment merges the cause of action in the judgment and the satisfaction of that judgment is a satisfaction and settlement of the whole cause of action.[14] Merely a partial satisfaction of the judgment does not extinguish the cause of action but does credit the amount paid to that due from the remaining tortfeasors.[15] Moreover, once satisfaction of judgment has been tendered, the court rendering the judgment cannot reserve the rights of the plaintiff against the other tortfeasors.[16] Since the plaintiff has an indivisible cause of action and can receive but one satisfaction for that cause, he has no right to split that single cause or apportion it. The court could not grant the plaintiff this right by its judgment; therefore, that portion of the judgment which reserves the plaintiff's rights would be inoperative as beyond the power of the court to render.[17] This implies that once the plaintiff accepts full satisfaction of a judgment from one defendant, it constitutes a release of the other defendant by operation of law notwithstanding

[12] Lovejoy v. Murray, 70 U.S. (3 Wall.) 1 (1865). RESTATEMENT, TORTS § 886 (1939). See Annot., 166 A.L.R. 1099 (1947), supplementing, Annots., 27 A.L.R. 805 (1923) and 65 A.L.R. 1087 (1930).

[13] See PROSSER, *op. cit. supra* note 4, at 241-42.

[14] City of Wetumka v. Cromwell-Franklin Oil Co., 171 Okla. 565, 43 P.2d 434 (1935); Cain v. Quannah Light & Ice Co., 131 Okla. 25, 267 Pac. 641 (1928).

[15] Lovejoy v. Murray, 70 U.S. (3 Wall.) 1, 17 (1865); 2 BLACK, JUDGMENTS § 782, at 1182 (2d ed. 1902).

[16] Eberle v. Sinclair Prairie Oil Co., 120 F.2d 746 (10th Cir. 1941); City of Wetumka v. Cromwell-Franklin Oil Co., 171 Okla. 565, 43 P.2d 434 (1935); Cain v. Quannah Light & Ice Co., 131 Okla. 25, 267 Pac. 641 (1928).

[17] City of Wetumka v. Cromwell-Franklin Oil Co., 171 Okla. at 566, 43 P.2d at 436; Cain v. Quannah Light & Ice Co., 131 Okla. at 28, 267 Pac. at 644.

the intentions of the parties in bringing the suit or the court in rendering its judgment. While no authority can be found in North Carolina in which a judgment reserved the rights of the plaintiff to proceed further, North Carolina has followed the same line of reasoning as the majority in holding that satisfaction of a judgment extinguishes the indivisible cause of action,[18] thereby indicating that the operation takes place by way of law rather than by construction.

A judgment by consent has been defined as an agreement or contract of the parties, acknowledged in court and ordered to be recorded, with the sanction of the court.[19] It is usually agreed to have dual aspects—that of an agreement between the parties and that of an entry of judgment by the court. Because of the contractual aspect of the consent judgment, it is always relevant in determining the effect of the judgment, to ascertain the intent of the parties.[20] However where there has been an agreement, consent judgment and satisfaction, the majority of cases do not distinguish between a judgment by consent and a judgment after trial and issue. In this situation the courts have rejected the contractual aspect, and hold that the satisfaction of the consent judgment extinguishes the cause of action by operation of law irrespective of the intention of the parties.[21] When applied to the joint tortfeasor situation this rule merely applies the basic law concerning satisfaction of judgment and dis-

[18] Bell v. Hankins, 249 N.C. 199, 105 S.E.2d 642 (1958); Burns v. Womble, 131 N.C. 173, 42 S.E. 573 (1902).

[19] Keach v. Keach, 217 Ky. 723, 290 S.W. 708 (1927); McArthur v. Thompson, 140 Neb. 408, 299 N.W. 519 (1941); McRary v. McRary, 228 N.C. 714, 47 S.E.2d 27 (1948); Union Bank v. Commissioners of Oxford, 119 N.C. 214, 25 S.E. 966 (1890); Blair v. Dickinson, 136 W. Va. 611, 68 S.E.2d 16 (1951).

[20] "The extent to which a judgment or decree entered by consent is conclusive in a subsequent action should be governed by the intention of the parties as expressed in the agreement which is the basis of the judgment and gathered from all the circumstances, rather than by a mechanical application of the general rules governing the scope of estoppel by judgment." Annot., 2 A.L.R.2d 514, 520 (1948).

[21] Eberle v. Sinclair Prairie Oil Co., 120 F.2d 746 (10th Cir. 1941); Jenkins v. Southern Pac. Co., 17 F. Supp. 820 (S.D. Cal. 1937); Battle v. Morris, 265 Ala. 581, 93 So.2d 428 (1957); Vattani v. Damiano, 9 N.J. Misc. 290, 153 Atl. 841 (Sup. Ct. 1931); Sykes v. Wright, 201 Okla. 346, 205 P.2d 1156 (1949); City of Wetumka v. Cromwell-Franklin Oil Co., 171 Okla. 565, 43 P.2d 434 (1935); Cain v. Quannah Light & Ice Co., 131 Okla. 25, 267 Pac. 641 (1928); Blake v. Kansas City So. Ry., 38 Tex. Civ. App. 337, 85 S.W. 430 (Civ. App. 1905). *Contra,* Colby v. Walker, 86 N.H. 568, 171 Atl. 774 (1934). See generally Annot., 135 A.L.R. 1498 (1941).

cards any notion of construction. This treatment by the courts has been described as a condition which society places on the parties as a price for the granting of judgment.[22] The effect of not exacting this price would be to give some credence to the contractual nature of a consent judgment and ultimately to the intention of the parties.[23] The court by imposing a rule of construction, would apply the same criteria it uses in construing releases and covenants not to sue.[24] If it could be seen from looking at the instrument as a whole that the plaintiff intended to receive full satisfaction from one defendant or to abandon his cause of action against that defendant, then the consent judgment should operate as a release, and plaintiff would be barred from further recovery.[25] If the construction showed that neither full satisfaction nor an abandonment were intended, then it should have the effect of a covenant not to sue.[26] By treating a consent judgment in this fashion, the court would be substituting a rule of construction for a rule of law.

North Carolina has recognized both the contractual and judgment aspects of the consent judgment. Many North Carolina cases hold that a consent judgment is res judicata between the parties in the same manner as a judgment after trial and issue.[27] There is also

[22] James, *Consent Judgments as Collateral Estoppel,* 108 U. PA. L. REV. 173, 176 (1959).

[23] Colby v. Walker, 86 N.H. 568, 171 Atl. 774 (1934). See Sykes v. Wright, 201 Okla. 346, 349, 205 P.2d 1156, 1160 (1949) (dissenting opinion).

[24] See 22 MINN. L. REV. 692 (1938); 30 N.C.L. REV. 75 (1951).

[25] *E.g.* Shapiro v. Embassy Dairy, Inc., 112 F. Supp. 696 (E.D.N.C. 1953); Westinghouse Elec. Supply Co. v. Burgess, 223 N.C. 97, 25 S.E.2d 390 (1943); Braswell v. Morrow, 195 N.C. 127, 141 S.E. 489 (1928); Sircey v. Hans Rees' Sons, 155 N.C. 296, 71 S.E. 310 (1911); Howard v. J. H. Harris Plumbing Co., 154 N.C. 224, 70 S.E. 285 (1911); Burns v. Womble, 131 N.C. 173, 42 S.E. 573 (1902); Brown v. Town of Louisburg, 126 N.C. 701, 36 S.E. 166 (1900).

[26] In North Carolina, a covenant not to sue does not release the other tortfeasors from the cause of action, however compensation from the covenantee is set off against any defendant who wishes to litigate rather than settle. Butler v. Norfolk So. Ry., 140 F. Supp. 601 (E.D.N.C. 1956); Ramsey v. Camp, 254 N.C. 443, 119 S.E.2d 209 (1961); Holland v. Southern Pub. Util. Co., 208 N.C. 289, 180 S.E. 592 (1935); Slade v. Sherrod, 175 N.C. 346, 95 S.E. 557 (1918); Winston v. Dalby, 64 N.C. 299 (1870).

[27] See Stone v. Carolina Coach Co., 238 N.C. 662, 78 S.E.2d 605 (1953); Herring v. Queen City Coach Co., 234 N.C. 51, 65 S.E.2d 505 (1951); Boucher v. Union Trust Co., 211 N.C. 377, 190 S.E. 226 (1937); Tilley v. Lindsey, 203 N.C. 410, 166 S.E. 168 (1932); Lalonde v. Hubbard, 202 N.C. 771, 164 S.E. 359 (1932); Morris v. Patterson, 180 N.C. 484, 105 S.E. 25 (1920); Simmons v. McCullin, 163 N.C. 409, 79 S.E. 625 (1913); Donnelly v. Wilcox, 113 N.C. 408, 18 S.E. 339 (1893). The language in the North Carolina cases is to the effect that a consent judgment is as binding on the

authority to the effect that a consent judgment is a decree of the parties, not of the court; that it should be construed as any other contract and that the judgment should be given effect in light of that construction.[28] By its decision in *Simpson v. Plyler*,[29] North Carolina has discarded those cases calling for construction of the consent judgment and has joined the majority in decreeing that satisfaction of the consent judgment extinguishes the cause of action by operation of law.

The question arises whether consent judgments should be given an effect beyond what the parties intended—should such a condition be imposed by society on the parties as a price for granting a judgment?[30] It is the opinion of the writer that the contractual nature of the consent judgment offers reasons for not doing so.

Since the doctrine of merger applies only when the judgment has been fully satisfied,[31] the question of satisfaction is highly important in raising the bar.[32] In a judgment by trial and issue, the

---

parties as a judgment after trial, and cannot be changed without consent of the parties or set aside except for fraud or mutual mistake.

[28] Cason v. Shute, 211 N.C. 195, 189 S.E. 494 (1937); Southern Eng'r Co. v. Boyd, 191 N.C. 143, 131 S.E. 305 (1926); Southern Distrib. Co. v. Carraway, 189 N.C. 420, 127 S.E. 427 (1925); Walker v. Walker, 185 N.C. 380, 117 S.E. 167 (1923); Holloway v. City of Durham, 176 N.C. 550, 97 S.E. 486 (1918); Idding v. Hiatt, 51 N.C. 402 (1859).

[29] 258 N.C. 390, 128 S.E.2d 843 (1963).

[30] See James, *Consent Judgments as Collateral Estoppel*, 108 U. PA. L. REV. 173 (1959), for the argument that the doctrine of collateral estoppel should not apply to consent judgments.

[31] "[W]hen the plaintiff has accepted satisfaction in full for the injury done him, from whatever source it may come, he is so far affected in equity and good conscience, that the law will not permit him to recover again for the same damages. But it is not easy to see how he is so affected, until he has received full satisfaction, or that which the law must consider as such." Lovejoy v. Murray, 70 U.S. (3 Wall.) 1, 17 (1865).

[32] "'[W]here the bar accrues in favor of some of the wrongdoers by reason of what has been received from or done in respect to one or more others, that the bar arises, not from any particular form that the proceeding assumes, but from the fact that the injured party has actually received satisfaction, or what in law is deemed the equivalent. Therefore, if he accepts the satisfaction voluntarily made by one, that is a bar to all. And so a release of one releases all, although the release expressly stipulates that the other defendants shall not be released. And this rule is held to apply, even though the one released was not in fact liable. It does not lie in the mouth of such plaintiff to say that he had no cause of action against one who paid him for his injuries, for the law presumes that the one who paid committed the trespass and occasioned the whole injury'. . . . It is immaterial whether the satisfaction is obtained by judgment and final process in execution of it or by amicable adjustment without any litigation of the claim for damages. The essential thing is satisfaction." Sircey v. Hans Rees' Sons, 155 N.C. 296, 300-01, 71 S.E. 310, 312 (1911).

damages of the plaintiff have been determined and set by the court serving in its judicial office so that it can readily be seen whether full or partial satisfaction has been received. In a consent judgment, however, the amount of satisfaction has been settled by the parties in their agreement and entered into the record by the court acting in its ministerial office.[33] Since the court has neither set nor determined the plaintiff's damages, it can not be seen from the payment of the judgment alone whether there has been full or partial satisfaction. Instead of flatly inferring full satisfaction, the better alternative to the court would be to construe the intent of the parties in the light of the circumstances to see whether full satisfaction was intended.

The argument for the finality of judgments[34] rests on the logic that if the consent judgment in the first suit is held to be binding in the second, it will diminish litigation by eliminating trials in both cases. However, if the first suit was not intended to be binding in the second, an ignorant party would be highly susceptible to entrapment. On the other hand, a party having knowledge of the binding effect would be less willing to compromise, resulting in more contested trials in the first suit. Thus the binding effect of a consent judgment would present a detriment to desirable compromise and would increase trials by contest.

The argument against double satisfaction[35] is feeble ground for the courts to tread in binding the plaintiff to a consent judgment in which full compensation was not in fact paid, since in such a situation the plaintiff might be inadequately compensated. By construing the consent judgment as a contract, the court could determine whether full satisfaction was or was not intended—thus better protecting the plaintiff against inadequate compensation as well as the defendant against double vexation.

J. D. WALSH

[33] The process in North Carolina is even less of a judicial determination because N.C. GEN. STAT. § 1-209(b) (1953), provides for the entry of consent judgments by the clerk of the Superior Court.

[34] See James, *supra* note 30, at 184-85.

[35] *Id.* at 185.

Corporations—De Facto Merger—Minority Shareholder's Appraisal Rights

At common law a dissenting shareholder could prevent corporate reorganization by merger,[1] consolidation,[2] or sale of assets[3] on the theory that such a change would violate the "contract of association" to incorporate for a particular purpose[4] or change the essential nature of the shareholder's investment.[5] In many instances shareholders took advantage of this right by threatening to enjoin proposed sales and mergers and thus were able to command exorbitant prices for their stock.[6] Due in part to this abuse and in part to a corporate need for more flexibility,[7] statutes have been passed restricting the right of dissatisfied shareholders to dissent from corporate transactions and allowing them to receive fair value[8] for their shares in specific instances.[9]

In many jurisdictions this right of dissenting shareholders is limited by statute to situations in which the proposed change in corporate form occurs by merger or consolidation.[10] Other jurisdictions grant a dissenting shareholder the right to invoke judicial aid when the corporate change occurs by sale of assets,[11] as well as by

[1] See, *e.g.*, Chicago Corp. v. Munds, 20 Del. Ch. 142, 149, 172 Atl. 452, 455 (1934) (dictum).

[2] See, *e.g.*, Spencer v. Railroad, 137 N.C. 107, 119-20, 49 S.E. 96, 101 (1904) (dictum). See also Carolina Coach Co. v. Hartness, 198 N.C. 524, 528, 152 S.E. 489, 491 (1930), which distinguished between merger and consolidation stating that "merger (is) the absorption of a thing of lesser importance by a greater, whereby the lesser ceases to exist, but the greater is not increased . . . . But . . . the legal effect of consolidation is to extinguish the constituent companies and create a new corporation." For a statutory distinction see N.C. GEN. STAT. § 55-110(a) (1960).

[3] See, *e.g.*, Geddes v. Anaconda Copper Mining Co., 254 U.S. 590, 598 (1921) (dictum); Kean v. Johnson, 9 N.J. Eq. 401, 414 (Ch. 1853).

[4] Lauman v. Lebanon Valley R.R., 30 Pa. 42 (1858).

[5] See Geddes v. Anaconda Copper Mining Co., 254 U.S. 590, 598 (1921) (dictum); Lauman v. Lebanon Valley R.R., *supra* note 4.

[6] See Johnson v. Baldwin, 221 S.C. 141, 154, 69 S.E.2d 585, 591 (1952) (dictum).

[7] See Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 228-30 (1962).

[8] See, *e.g.*, N.C. GEN. STAT. § 55-113(c), (e) (1960), which designates the time for appraisal and places a minimum limitation on "fair value."

[9] See, *e.g.*, N.C. GEN. STAT. § 55-113 (1960).

[10] See, *e.g.*, DEL. CODE ANN. tit. 8, § 262 (1953). Eight states provide that merger and consolidation shall be the only triggering transactions. For a list of these see Manning, *supra* note 7, at 262-63.

[11] See, *e.g.*, N.C. GEN. STAT. § 55-113 (1960); PA. STAT. ANN. tit. 15, § 2852-311(D) (1958); N.J. STAT. ANN. § 14:3-5 (1939).

merger and consolidation.[12] Since a sale of assets may have the same end result as a merger,[13] dissatisfied shareholders in jurisdictions which do not provide a statutory right of appraisal upon a sale of assets have contended for recognition of the judicial doctrine of *de facto* merger. That is, the shareholder contends:

> that the transaction, though in form a sale of assets . . . is in substance and effect a merger, and that it is unlawful because the merger statute has not been complied with, thereby depriving (the shareholder) of his right of appraisal.[14]

In Delaware, where statutory appraisal rights are accorded only in instances of merger and consolidation,[15] the supreme court recently rejected such a contention in *Hariton v. Arco Electronics, Inc.*[16] Arco Electronics proposed to sell its assets to Loral Electronics pursuant to the Delaware sale-of-assets statute.[17] Arco was to transfer its assets to Loral in exchange for Loral stock and the assumption by Loral of all Arco's liabilities. Upon closing the transaction Arco was to distribute the Loral stock to its shareholders and dissolve. A minority shareholder in the selling corporation brought suit to enjoin the proposed sale, contending that the transaction was a *de facto* merger.[18]

While recognizing that the sale of assets had the same effect as would have been achieved by merger, the court pointed out that this result was permitted by the overlapping scope of the merger statute and the sale-of-assets statute.[19] The court made no reference to the

[12] All states except West Virginia provide for appraisal rights to dissenting shareholders upon merger or consolidation.

[13] See text at notes 17-18 *infra.*

[14] Hariton v. Arco Electronics, Inc., 182 A.2d 22, 24 (Del. Ch. 1962), *aff'd,* 188 A.2d 123 (Del. 1963).

[15] DEL. CODE ANN. tit. 8, § 262 (1953).

[16] 188 A.2d 123 (Del. 1963), *affirming* 182 A.2d 22 (Del. Ch. 1962). For a complete discussion of the implications of this case see Folk, *De Facto Mergers In Delaware: Hariton v. Arco Electronics, Inc.,* 49 Va. L. Rev. 1261 (1963).

[17] DEL. CODE ANN. tit. 8, § 271 (1953).

[18] In Heilbrun v. Sun Chemical Co., 38 Del. Ch. 321, 150 A.2d 755 (Sup. Ct. 1959), *affirming* 37 Del. Ch. 552, 146 A.2d 757 (Ch. 1958), the Delaware court had "expressly observed" the issue which arose in *Hariton,* but had refused to decide it because the complaining shareholder was a member of the *purchasing* corporation and was deemed not to have suffered any damage.

[19] "This is so because the sale of assets statute and the merger statute are independent of each other. They are, so to speak, of equal dignity, and the framers of a reorganization plan may resort to either type of corporate

shareholder's claim that he was being forced to accept stock in a different corporation. However, the lower court had given the following answer to that contention:

> The stockholder was, in contemplation of law, aware of this right (to make a sale of assets to another corporation) when he acquired the stock. He was also aware of the fact that the situation might develop whereby he would be ultimately forced to accept a new investment, . . .[20]

On the other hand Pennsylvania, another important commercial jurisdiction, has found considerably more merit in the *de facto* merger doctrine. In *Farris v. Glen Alden Corp.*[21] the Pennsylvania court said that the appraisal remedy was available in any case where the new corporate combination effected a change in the essential nature of the corporation, or disturbed the relationship existing between shareholders or between shareholders and the corporation. Since the reorganization changed Glen Alden from a coal mining company into a diversified company with additional holdings in the fields of entertainment, real estate, and manufacturing, the court said that its "corporate character" had been changed.[22]

Before granting appraisal rights to a shareholder of the purchasing corporation, however, the Pennsylvania court still had a difficult obstacle to hurdle. Faced with statutory language granting the appraisal remedy to a seller of assets[23] but expressly denying it to a purchaser,[24] the court said that the statute only applied to instances in which reorganization was accomplished by a sale of assets *without*

---

mechanics to achieve the desired end." Hariton v. Arco Electronics, Inc., 188 A.2d 123, 125 (Del. 1963), *affirming* 182 A.2d 22 (Del. Ch. 1962).

[20] Hariton v. Arco Electronics, Inc., *supra* note 19, at 26. Although *Hariton* would seem to preclude the application of the *de facto* merger doctrine in Delaware, the court still purports to recognize the doctrine. See Orzeck v. Englehart, 195 A.2d 375 (Del. 1963), *affirming* 192 A.2d 36 (Del. Ch. 1963). However the court has only applied the doctrine where the parties to the reorganization failed to comply with some statutory provision pertaining to the transaction, to the prejudice of the shareholder. See Drug, Inc. v. Hunt, 35 Del. 339, 168 Atl. 87 (1933); Finch v. Warrior Cement Corp., 16 Del. Ch. 44, 141 Atl. 54 (1928).

[21] 393 Pa. 427, 143 A.2d 25 (1958).

[22] Other Pennsylvania cases have been decided along similar lines. See Troupiansky v. Henry Disston & Sons, 151 F. Supp. 609 (E.D. Pa. 1957); Marks v. Autocar Co., 153 F. Supp. 768 (E.D. Pa. 1954); Bloch v. Baldwin Locomotive Works, 75 Pa. D. & C. 24 (C.P. 1950).

[23] PA. STAT. ANN. tit. 15, § 2852-311(D) (1958).

[24] PA. STAT. ANN tit. 15, § 2852-908(C) (1958).

more and that if the shareholder's common law rights were to be abrogated, a more specific statute was necessary.[25] Then, almost as an afterthought, the court advanced another, perhaps sounder, principle upon which the decision could be based. The court recognized that *Glen Alden* presented a situation in which the corporation designated by the parties as the seller was actually the buyer,[26] and said that in such a situation it would look through the nominal designation of the parties to the substance of the transaction.

Further, the New Jersey court has recognized the *de facto* merger doctrine in a similar situation. An exchange of one corporation's shares for those of another can bear as much resemblance to merger and consolidation as does a sale of assets for shares in the buying corporation.[27] In *Applestein v. United Board & Carton Corp.*[28] the New Jersey court held that a transaction intended to effect a consolidation by means of an exchange of shares and a subsequent dissolution of the smaller corporation so closely resembled a *de jure* merger that it would be treated as a merger in fact. New Jersery has a statutory scheme granting appraisal rights when there is a merger,[29] consolidation,[30] or sale of assets[31]—making no mention of exchange of shares. However, the court said that it made no difference because "every factor present in a corporate merger is

[25] The court reached this decision despite the express language of the statute and evidence that this interpretation was contrary to the intention of the drafters of the statute. See Farris v. Glen Alden Corp., 393 Pa. 427, 436-37, 143 A.2d 25, 30-31 (1958).

[26] Previous to the reorganization, List (the "seller") owned 38.5% of Glen Alden's (the "buyer") stock. When Glen Alden acquired all the stock of List for its own stock, this gave List effective control of Glen Alden with 76.5% of Glen Alden's stock. This problem has been settled in regard to which party receives appraisal rights by PA. STAT. ANN. tit. 15, § 2852-311(F) (Supp. 1962), which denies appraisal rights to the buyer unless it makes the purchase with more than 50% of its voting shares.

[27] In Orzeck v. Englehart, 192 A.2d 36, 38 (Del. Ch. 1963), *aff'd*, 195 A.2d 375 (Del. 1963), the court said that a sale of assets and an exchange of shares are not so similar that the same reasoning should apply to both in regard to *de facto* merger. This position may be reached by distinguishing the component parts of the transactions; however, from the position of a dissenting shareholder, the end result of one may be indistinguishable from the other.

[28] 60 N.J. Super. 333, 159 A.2d 146 (Ch.), *aff'd per curiam*, 33 N.J. 72, 161 A.2d 474 (1960).

[29] N.J. STAT. ANN. § 14:12-6 (Supp. 1962).

[30] *Ibid.*

[31] N.J. STAT. ANN. § 14:3-5 (1939).

found in this . . . plan, except . . . a formal designation of the transaction as a 'merger.' "[32]

Both the Delaware and the Pennsylvania-New Jersey views on the *de facto* merger doctrine have some merit. No statute grants appraisal rights in a purchase of assets or an exchange of shares situation; therefore, if the statute is interpreted as an exclusive remedy, there can be no *de facto* merger doctrine. It is worth noting that more than half the appraisal statutes expressly grant appraisal rights for a sale of assets,[33] so that the omission of purchase of assets might be deemed intentional.[34] Furthermore, a shareholder could not prevent an exchange of shares at common law,[35] and it can, therefore, be argued that the want of an appraisal remedy in such a situation does not deprive the shareholder of any former right.[36] Neither the Pennsylvania nor the New Jersey court has decided the exact elements necessary to constitute a *de facto* merger, and this lack of certainty would cause litigation in practically every case,[37] thereby diminishing the advantage which the appraisal remedy would afford the shareholder, while still allowing the shareholder to "hold up" the corporation due to the expense of defending against claims.[38] Any hard and fast rule that the court would treat as a merger any sale of assets or exchange of shares which had the same effect as a merger would, in effect, remove from consideration all means of corporate reorganization except merger.[39]

On the other hand the fact that practically all jurisdictions grant appraisal rights to all shareholders who dissent from a merger[40] would seem to indicate that courts still adhere to the theory that one should not be compelled to accept stock in a different corpora-

[32] Applestein v. United Board & Carton Corp., 60 N.J. Super. 333, 348, 159 A.2d 146, 154 (Ch.), *aff'd per curiam*, 33 N.J. 72, 161 A.2d 474 (1960).

[33] Thirty-seven states grant appraisal upon a sale of assets. For a list of these see Manning, *supra* note 7, at 262-65.

[34] This was relied on in Hariton v. Arco Electronics, Inc., 182 A.2d 22, 25 (Del. Ch. 1962), *aff'd*, 188 A.2d 123 (Del. 1963).

[35] At common law the only check on the right of alienation was an action for fraud. Presently this right is checked by a fiduciary duty toward the minority imposed upon directors and officers. See Folk, *supra* note 16, at 1276.

[36] See text at notes 1-5 *supra*. Also see Note, 58 COL. L. REV. 251, 253 (1958).

[37] See Note, 72 HARV. L. REV. 1132, 1144 (1959).

[38] *Id.* at 1133 n.6.

[39] See Folk, *supra* note 16, at 1276.

[40] See note 11 *supra*.

tion.[41] As a sale of assets or exchange of shares, when coupled with an assumption of the seller's liabilities by the buyer and compelled dissolution of the seller, places the minority shareholder in exactly the same position as does a merger, it would seem logically inconsistent to refuse the shareholder the remedy which is available in a merger.[42] The appraisal argument is not very compelling when the business is merely changed from a coal mining company to an ice cream company;[43] however, when the change is from an income company to a growth company and the shareholder cannot readily dispose of his interest, the argument is more persuasive because the shareholder's investment has truly been changed.

The appraisal provisions of the North Carolina Business Corporation Act are similar to those of Pennsylvania and New Jersey in that the act expressly grants appraisal rights for merger, consolidation, and sale of assets.[44] Like the statutes of all other jurisdictions, the act does not provide for appraisal rights upon a purchase of assets or exchange of shares. There are no decisions which indicate whether the court would accept the *de facto* merger doctrine; therefore the matter is open for speculation. The only indication of intent left by the drafters of the act is the statement that appraisal rights are given for sales of assets because this is "frequently nothing more than a *de factor* (sic) merger and hence should be analogized to merger as much as possible."[45]

As the North Carolina court is not bound by any existing precedent, it may select either path in deciding whether to grant

[41] Delaware holds to the contrary. See Hariton v. Arco Electronics, Inc., 182 A.2d 23, 26 (Del. Ch. 1962), *aff'd*, 188 A.2d 123 (Del. 1963).

[42] See Note, 72 HARV. L. REV. 1132, 1143 (1959).

[43] If only the type of business in which the corporation is engaged is changed, this would seem an insufficient reason to grant appraisal rights as the same results could be reached by charter amendment or a change in the "business policy" of the corporation, neither of which would trigger any appraisal statute.

[44] N.C. GEN. STAT. § 55-113 (1960) provides that the sale of assets must be for shares of the purchasing corporation before appraisal rights are granted. In addition to transactions under consideration in connection with *de facto* merger, the North Carolina act also allows appraisal rights in the event of the following: charter amendments which would change the corporation into a non-profit or cooperative organization; charter amendments or offers of exchange which would affect dividend and liquidation preferences; and liquidation by transfer of assets in kind to shareholders. See N.C. GEN. STAT. § 55-101(b) (1960); N.C. GEN. STAT. § 55-102 (1960); N.C. GEN. STAT. § 55-119(b) (1960).

[45] S. 49, N.C. Sess. 1955, § 112 (comment).

appraisal rights for transactions not specifically mentioned by statute. The case-law emphasis in other jurisdictions has been concerned with broad interpretations of legislative intent; however, the real problem is that the form of the transaction has been made the controlling factor while the pertinent question of whether there should be appraisal rights at all has been overlooked. The granting of this remedy compels a loss of mobility to the corporation[46] and reduces the speed and effectiveness with which the corporation can make decisions. It is expensive[47] and uncertain, as the corporation never knows how many dissenters to expect. The resulting flow of cash away from the corporation may frighten creditors and cause reorganization plans to be cancelled.[48] These may well be adequate reasons for refusing appraisal rights in all situations, but deciding whether or not they are to be granted on the basis of the form of the transaction alone does not meet the problem squarely. Certainly such a rule enables a corporation to avoid granting appraisal rights simply by adopting a certain form for the transaction, but even the severest critics of appraisal rights admit their utility in "no market" situations[49] which are often found when dealing with closely held corporations. To grant relief in such situations and still preserve a maximum of corporate freedom, granting the remedy should depend on the effect of the transactions, rather than their form, and this would involve a thorough revamping of the appraisal statutes.

WALTER RAND, III

Corporations—Unlawful Proxy Solicitation Under Securities Exchange Act—Rights of Shareholders—Jurisdiction of Federal Courts to Grant Retrospective Relief

Under section 14(a) of the Securities Exchange Act of 1934,[1] it is unlawful to solicit proxies in violation of the Securities Ex-

[46] See Note, 59 COL. L. REV. 366, 368 (1959).

[47] In Farris v. Glen Alden Corp., 393 Pa. 427, 431 n.5, 143 A.2d 25, 28 n.5 (1958), it was conceded that the reorganization plan would fail if appraisal rights were given, due to the expense involved.

[48] For a good discussion of "the company's perspective" see Manning, *supra* note 7, at 233-39.

[49] *Id.* at 260-62.

[1] "It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce... or otherwise to solicit or permit the use of his name to solicit any proxy... in respect of any se-

change Commission's rules promulgated thereunder.[2] The proxy rules apply to securities listed and registered on a national exchange.[3] The Commission is empowered to enforce the provisions of the act by seeking a federal district court injunction against further violations.[4] Recently the courts have been faced with deciding whether a right enforceable in the courts is created in private parties (as opposed to the Commission) by section 14(a). Broadly speaking, there are two questions to be considered in connection with this problem: (1) Does a private right of action exist for injuries suffered or threatened from a violation of section 14(a), and if so, who may assert it, and (2) who has the power to grant relief to a party injured by such a violation?

In three recent decisions, it has been expressly held that a right of action is created in an individual stockholder by a violation of section 14(a) and the Commission's proxy rules, notwithstanding the fact that the act does not expressly provide for such.[5] Such a right of action is based on "the general rule that a breach of statutory duty normally gives rise to a right of action on behalf of the in-

curity (other than an exempted security) registered on any national securities exchange in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 48 Stat. 895 (1934), 15 U.S.C. § 78n(a) (1958).

[2] 17 C.F.R. §§ 240.14a-1 to -11 (Supp. 1963).

[3] 17 C.F.R. § 240.14a-2 (Supp. 1963).

[4] SECURITIES EXCHANGE ACT § 21(e), 48 Stat. 899 (1934), as amended, 15 U.S.C. § 78u(e) (1958). Although the Commission is merely empowered to seek an injunction against further violations of the act, the courts will go beyond this and enjoin the use of the proxies illegally solicited as equity will not allow the wrongdoer to profit by his wrongdoing. SEC v. May, 134 F. Supp. 247 (S.D.N.Y. 1955), *aff'd*, 229 F.2d 123 (2d Cir. 1956); Central Foundry Co. v. Gondelman, 166 F. Supp. 429 (S.D.N.Y.), *modified sub nom.*, SEC v. Central Foundry Co., 167 F. Supp. 821 (S.D.N.Y. 1958).

[5] Borak v. J. I. Case Co., 317 F.2d 838 (7th Cir. 1963), *cert. granted*, 32 U.S.L. WEEK 3173 (U.S. Nov. 12, 1963) (No. 402); Dann v. Studebaker-Packard Corp., 288 F.2d 201 (6th Cir. 1961); Walsh & Levine v. Peoria & E. Ry., 222 F. Supp. 516 (S.D.N.Y. 1963) (dismissed for failure to join indispensable parties). Before these decisions, there had been dicta both to the effect that there was a right of action and to the effect there was not. Assuming its existence, Mack v. Mishkin, 172 F. Supp. 885 (S.D.N.Y. 1959). *Contra*, Howard v. Furst, 140 F. Supp. 507 (S.D.N.Y.), *aff'd*, 238 F.2d 790 (2d Cir. 1956), *cert. denied*, 353 U.S. 937 (1957).

It does not seem that all of the Commission's proxy rules would support a private action, especially after the vote had been taken. Some of the rules are of administrative importance only. See SEC Reg. 14a-6(a), 17 C.F.R. § 240.14a-6(a) (Supp. 1963), which requires that copies of any proxy material be furnished to the Commission ten days in advance of solicitation.

jured persons for whose benefit the statute was enacted."[6] Specifically, section 14(a) has been interpreted to give the stockholder the "right to a full and fair disclosure of all material facts which affect corporate elections by proxy,"[7] and to place the proxy solicitor under a duty to provide such disclosure by obeying the proxy rules.[8] This duty is owed the stockholder because the purpose of section 14(a) is to protect the voting rights of stockholders.[9] To enforce this right, the stockholder has a personal right of action.[10]

The second problem, the one confronting the courts today, is whether the federal courts possess the power to give relief to a stockholder injured by a violation of section 14(a) who subsequently brings a suit on the theory outlined above. There seems to be no doubt that an adverse party is entitled to "prospective relief," *i.e.*, injunction against the use of proxies obtained in violation of section 14(a).[11] However, whether corporate elections or action authorized

[6] Dann v. Studebaker-Packard Corp., *supra* note 5, at 208-09. *Accord,* Walsh & Levine v. Peoria & E. Ry., *supra* note 5, at 519. See RESTATEMENT, TORTS, § 286 (1934). In so holding, the courts reject the maxim of statutory construction, *expressio unius est exclusio alterius* (the expression of one thing is the exclusion of another), which might have been applicable because Congress expressly provided for civil remedies under three sections of the act: § 9(e), 48 Stat. 889 (1934), 15 U.S.C. § 78i(e) (1958) (manipulation of prices); § 16(b), 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1958) (recovery of "insider" profits); § 18, 48 Stat. 897 (1934), as amended, 15 U.S.C. 78r (1958) (reliance on misleading statements in material filed pursuant to the act when buying or selling). This is in accord with the upholding of private rights of action under other sections of the act where not expressly provided for. *E.g.,* Hooper v. Mountain States Securities Corp., 282 F.2d 195 (5th Cir. 1960), *cert. denied,* 365 U.S. 814 (1961) (implying a right of action for violation of § 10(b), 48 Stat. 891 (1934), 15 U.S.C. 78j(b) (1958), and SEC Reg. 10b-5, 17 C.F.R. § 240.10b-5 [1949]).

[7] Borak v. J. I. Case Co., 317 F.2d 838, 848 (7th Cir. 1963), *cert. granted,* 32 U.S.L. WEEK 3173 (U.S. Nov. 12, 1963) (No. 402).

[8] See Dann v. Studebaker-Packard Corp., 288 F.2d 201, 208 (6th Cir. 1961).

[9] Dann v. Studebaker-Packard Corp., *supra* note 8 at 207-08.

[10] It has been held that there is no right of action when the damage to the stockholder is of a derivative nature. Howard v. Furst, 140 F. Supp. 507 (S.D.N.Y.), *aff'd,* 238 F.2d 790 (2d Cir. 1956), *cert. denied,* 353 U.S. 937 (1957). This decision has been criticized heavily. See 2 Loss, SECURITIES REGULATION 950-51 (2d ed. 1961); 70 HARV. L. REV. 1493 (1957). While this limits the right of action, it is in accordance with the statute which is aimed at the protection of the personal right of the stockholder to cast his vote knowing all the facts. Dann v. Studebaker-Packard Corp., 288 F.2d 201, 207-08 (6th Cir. 1961).

[11] See note 4 *supra,* regarding courts enjoining the use of illegally solicited proxies even though not expressly authorized to do so when the Commission is plaintiff. In Central Foundry Co. v. Gondelman, 166 F. Supp. 429

by illegally solicited proxies may be set aside or damages awarded if recision should prove inequitable is less clear. The cases have split on the question of the jurisdiction of the federal courts to grant "retrospective relief" for such violations.[12]

In *Borak v. J. I. Case Co.*,[13] the plaintiff stockholder brought a class action on behalf of himself and all other stockholders similarly situated against the defendant corporation, its officers, and directors in a federal district court. Plaintiff alleged that a merger and a stock option plan were approved at a special stockholder's meeting by the use of proxies solicited in violation of section 14(a). Plaintiff also alleged that the agreements were void contracts under the provisions of section 29(b) of the act[14] because they were made pursuant to a violation of sec. 14(a). He asked that the merger be declared void and that damages and such other relief as equity might

(S.D.N.Y.), *modified sub nom.*, SEC v. Central Foundry Co., 167 F. Supp. 821 (S.D.N.Y. 1958), both director-stockholders and the Commission were plaintiffs. The court declared the proxies void and adjourned the meeting until another solicitation with adequate facts could be held. *Dann v. Studebaker-Packard Corp.* also recognized jurisdiction to grant this "prospective" relief. 288 F.2d at 214.

[12] Holding there is jurisdiction to grant "retrospective" relief: Borak v. J. I. Case Co., 317 F.2d 838 (7th Cir. 1963), *cert. granted*, 32 U.S.L. WEEK 3173 (U.S. Nov. 12, 1963) (No. 402); Walsh & Levine v. Peoria & E. Ry., 222 F. Supp. 516 (S.D.N.Y. 1963). Holding that federal jurisdiction is limited to "prospective" relief: Dann v. Studebaker-Packard Corp., 288 F.2d 201 (6th Cir. 1961).

[13] *Supra* note 12.

[14] "Every contract made in violation of any provision of this chapter... and every contract... the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this chapter... shall be void (1) as regards the rights of any person who, in violation of any such provision... shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision...." 48 Stat. 903 (1934), as amended, 15 U.S.C. § 78cc(b) (1958).

An alternative theory for upholding the plaintiff's right of action may be found here. The proxy is treated as a contract and its solicitation in violation of § 14(a) makes it void. See Brief for the SEC as Amicus Curiae, pp. 15-16, Borak v. J. I. Case Co., 317 F.2d 838 (7th Cir. 1963); Comment, *Private Rights and Remedies under the S.E.C. Proxy Rules*, 3 B.C. IND. & COM. L. REV. 58, 59 (1961). It has been held that under the general rule implying a right of action from the statute, the plaintiff does not have to show that he was even solicited. Dann v. Studebaker-Packard Corp., 288 F.2d 201, 209 (6th Cir. 1961). Here however, plaintiff might have to show that he was solicited and gave his proxy in order to have standing to sue as a party to the contract.

see fit be granted. The district court held that the federal court's jurisdiction to grant relief is limited to a declaratory judgment as to the validity or invalidity of the proxies once they had been voted.[15] The Seventh Circuit Court of Appeals reversed the district court, and held that section 27 of the act[16] confers jurisdiction upon the federal courts to award damages or to grant discretionary equitable relief, although retrospective, as the merits of the case require.[17]

In so holding, the court analyzed *Dann v. Studebaker-Packard Corp.*,[18] on which the district court relied, and concluded that the *Dann* court had taken a mistaken view of the jurisdictional grant of section 27.[19] In *Dann,* plaintiff stockholder asked that Studebaker-Packard be returned to the economic position it held prior to the consummation of certain "arrangements" between Studebaker-Packard and another corporation, if the court, discounting void proxies solicited in violation of section 14(a), found that the two-thirds majority vote necessary under Michigan law for approval of the transaction was wanting. Plaintiff alleged that jurisdiction was conferred upon the federal courts to grant such relief by section 27 of the act[20] and section 1331 of the Judicial Code.[21] The *Dann* court adopted the view that the ultimate decisions involved in the case, *i.e.,* what were the consequent effects of the validity or invalidity of the proxies, were so strictly questions of state corporation law that, in the absence of a clear mandate to do so by Congress, the federal courts should not assume jurisdiction to decide them.[22] *Gully v.*

[15] 317 F.2d at 841.

[16] "The district courts of the United States... shall have exclusive jurisdiction of violations of this chapter... and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder.... Any suit or action to enforce any liability or duty created by this chapter... or to enjoin any violation of such chapter... may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process ... may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found." 48 Stat. 902 (1934), as amended, 15 U.S.C. § 78aa (1958).

[17] 317 F.2d at 849.

[18] 288 F.2d 201 (6th Cir. 1961).

[19] 317 F.2d at 848-49.

[20] See note 16 *supra.*

[21] "The district courts shall have original jurisdiction of all civil actions wherein the matter in controversy... arises under the... laws... of the United States." 28 U.S.C. 1331 (1958).

[22] 288 F.2d at 214.

First Nat'l Bank[23] was cited as the basis for the court's decision to end federal jurisdiction with the voting of the proxies. *Gully* stands for the proposition that "to arise under the laws of the United States" so as to give the federal courts jurisdiction, the federal right must be the primary right asserted and not merely a collateral one. The federal right which plaintiff sought to assert in *Dann* was found to be "really negligible in comparison" to the state questions which would have to be decided.[24] Thus, even though the federal right asserted by the plaintiff "would probably be material to the ultimate outcome"[25] it was merely collateral to the primary question, the validity of a corporate vote, which arose under state law.[26]

Borak, in disagreeing, pointed out that the "jurisdictional facts" in these cases were totally different from those in *Gully.*[27] In *Gully,* it was held that there was no case "arising under the laws of the United States," and consequently, no federal jurisdiction, where the right plaintiff sought to assert (collection of a tax) was actually given by a state statute and the only connection that could be shown with federal law was that a federal statute allowed the states to pass such statutes.[28] However, in the principal case and *Dann,* a right given by the federal statute was directly violated and it was the violation of his federal right that the plaintiff asserted as the basis for redress. For this reason, the *Gully* decision is not applicable to *Borak.*[29] Rather, the court viewed the doctrine set forth in *Bell v. Hood*[30] as the better reasoning. As the court somewhat loosely stated that doctrine: "[F]ederal courts have the power, under a general grant of jurisdiction to enforce a federal statute, to grant all of the relief . . . commensurate with the effective enforcement of the statute, and the protection of rights created thereby . . . ."[31] As section 14(a) created a right to "full and fair disclosure," the jurisdiction given the courts by section 27 is large enough in scope under this doctrine to encompass damages or other retrospective relief as might be

[23] 299 U.S. 109 (1936).
[24] 288 F.2d at 214.
[25] *Ibid.*
[26] *Id.* at 215.
[27] 317 F.2d at 848.
[28] 299 U.S. at 116.
[29] 317 F.2d at 848.
[30] 327 U.S. 678 (1946).
[31] 317 F.2d at 848.

necessary in the individual case to fully protect the right.[32] Ample support for this doctrine was found in the cases.[33]

If the Supreme Court crosses the first hurdle and upholds the private right of action for a violation of section 14(a),[34] it will be faced with choosing between these views of the jurisdictional grant of section 27. Because of the fact that section 27 provides for "exclusive jurisdiction" in the federal district courts to enforce liabilities or duties created by the act,[35] either result would have a definite effect on the future rights of shareholders to enforce private rights of action under the Securities Exchange Act.

Clearly it seems that the *Gully* case on which *Dann* relied is inapplicable to this situation where there is a direct violation of a federal statute. However, the problem raised by *Dann,* whether the validity of the vote is a matter of state law or of federal law, is critical. It results from the fact that the federal law regulating proxy solicitation is "super-imposed" on the general body of state corporation law governing the validity of corporate votes and the consequences of invalidity.[36] If we disregard the discredited reliance on *Gully,*[37] it would seem that the basis of the *Dann* court's decision was that it could find no Congressional intent to create a right which would involve determinations of what have traditionally been matters of state law.[38] The court seemed to think that deciding questions in

[32] *Id.* at 849.

[33] Although the remedy was not specifically provided for in the statutes under which the following actions were brought, the Court held that it could grant the relief necessary to accomplish full justice: Mitchell v. Robert Demario Jewelry, Inc., 361 U.S. 288 (1960) (authority to order defendant to reimburse for wages lost through a violation of the Fair Labor Standards Act of 1938); Schine Chain Theatres, Inc., v. United States, 334 U.S. 110 (1948) (power to order a violator of the Sherman Antitrust Act to divest himself of holdings unlawfully acquired); Porter v. Warner Holding Co., 328 U.S. 395 (1946) (traditional equity powers used to order restitution of rents above the maximum allowed by the Emergency Price Control Act of 1942).

[34] It would seem that the Court will be constrained to uphold the private right of action in view of the body of law which has grown up around SEC Reg. 10b-5. The section of the act it is promulgated under, § 10(b), like § 14(a), does not provide any private remedy for its violation. See note 6 *supra.*

[35] *Supra* note 16.

[36] See 2 Loss, *op. cit. supra* note 9, at 973.

[37] The *Dann* court's reliance on *Gully* is criticized in the following: Comment, *Private Rights and Remedies under the S.E.C. Proxy Rules,* 3 B.C. IND. & COM. L. REV., 58, 67 (1962); 75 HARV. L. REV. 637, 639 (1962).

[38] 288 F.2d at 212, 214.

these areas would be a judicial "federalizing" of state law, and this it was not willing to do. So it ended federal jurisdiction with the declaratory judgment even though realizing that such a decision meant "eating away at the vital principle that for every federal right, there should be a complete federal remedy."[39]

Borak, on the other hand, took the position that the "federalizing" was done by Congress when it chose to enter the field with such a strong program of requiring "full and fair disclosure" to investors in securities. The jurisdictional grant of section 27, extending as it does to all suits brought to enforce any liability or duty created by the act, thereby encompasses the traditional power to give a full federal remedy for the violation of a federal right.[40] One theory justifying this approach is that there is no question of "state law" involved. Such a conclusion finds support in *Textile Workers Union v. Lincoln Mills.*[41] In that case it was held that a mere grant of jurisdiction to entertain suits arising out of violations of contracts in the labor field gave rise to substantive law which was to be fashioned by the courts out of the legislative policy embodied in the national labor statutes.[42] The Securities Exchange Act of 1934 expresses a policy no less broad than that of the Taft-Hartley Act,[43] and the fact that jurisdiction to hear suits arising out of violations of the act is exclusively reposed in the federal courts is favorable evidence of Congressional intent that the rights vindicated by suit would be decided as federal law under the protective eye of its own courts. Such a view is bolstered by holdings to the effect that in areas where there is federal jurisdiction, but no federal law on a specific question, state law may be adopted if compatible with the federal aims.[44] The adoption of state law surrounding the corporate vote in determining whether plaintiff has been injured would be

[39] *Id.* at 214.
[40] 317 F.2d at 849.
[41] 353 U.S. 448 (1957).
[42] *Id.* at 456.
[43] A former Chairman of the Commission expressed the function of the proxy rules and the policy behind them in this manner: "The proxy rules are a vital part of the shareholders' 'Bundle of rights.' They afford a means by which shareholders can exercise an informed judgment.... They implement the fundamental concern of the Congress expressed in the federal securities laws for the public investor." Armstrong, *Introduction to* ARANOW & EINHORN, PROXY CONTESTS FOR CORPORATE CONTROL at xxiii (1957).
[44] *E.g.,* Textile Workers Union v. Lincoln Mills, 353 U.S. 448 (1957); Board of Comm'rs, v. United States, 308 U.S. 343 (1939).

highly desirable solution as it would favor various local policies while redressing the violations of the federally created right.

From a practical standpoint, *Borak* seems to be the more desirable of the two decisions. If *Dann* is followed, the state courts could still refuse to take jurisdiction by holding that in determining the consequent effects of invalid proxies, they would be enforcing a liability created by the federal law, in contravention of the exclusive jurisdiction provision of section 27.[45] Furthermore, even if the state courts did take jurisdiction to decide the "state law" aspects of the action, two actions would be necessary before relief could be granted. Besides the time and money lost in this litigation, plaintiff would also lose the benefits of liberal venue and nationwide service of process available under section 27.[46]

Moreover, *Borak* carries out the purpose of section 14(a), protecting investors in securities, to a much greater degree than *Dann*. The very fact that the private action exists in addition to the enforcement by the Commission adds to the protection afforded by the act.[47] The decision also serves as a warning that any advantage obtained through illegal solicitation may be taken away in a private action after the vote. As such, it is a psychological weapon against those who would make use of such methods.

ROBERT B. LONG, JR.

Liability of Continuing Shareholder for Constructive Dividend

When a closely held corporation redeems the shares of one stockholder, the threat of a constructive dividend may present tax problems for the continuing shareholder. The problem arises when one major shareholder has decided to leave the corporation and another wishes to remain. Basically, there are two ways for the continuing shareholder to acquire complete ownership of the corporation: (1) the continuing shareholder may use his personal funds to

[45] State courts have so far refused to hear any claim or defense based upon § 14(a) because of § 27. *E.g.*, Investments Associates, Inc. v. Standard Power & Light Corp., 29 Del. Ch. 225, 48 A.2d 501 (Ch. 1946), *aff'd*, 29 Del. Ch. 593, 51 A.2d 572 (Sup. Ct. 1947); Eliasberg v. Standard Oil Co., 23 N.J. Super. 431, 92 A.2d 862 (Ch. 1952), *aff'd per curiam*, 12 N.J. 467, 97 A.2d 437 (1953).

[46] See these provisions of § 27 in note 16 *supra*.

[47] Brief for the SEC as Amicus Curiae, p. 21, Borak v. J. I. Case Co., 317 F.2d 838 (7th Cir. 1963).

purchase the shares of the retiring stockholder, or (2) the corporation may use its funds to redeem the shares of the retiring stockholder.

There is at least one persuasive reason for having the corporation redeem the shares rather than having the remaining shareholder make the purchase. The remaining shareholder's personal funds may be insufficient to purchase the shares of the departing shareholder, and he may have to look to the corporation itself for the funds needed to purchase the retiring shareholder's interest. If the continuing stockholder takes corporate funds into his own hands in order to purchase the shares of the retiring stockholder, there must be a dividend declared to him; and, therefore, a personal income tax will be precipitated at the shareholder level. The consequence of this tax may leave the continuing shareholder with insufficient funds to purchase the shares of the retiring stockholder. It thus becomes a matter of tax economy[1] (and often a matter of economic necessity) that the continuing shareholder so arrange the transaction that no dividend need be declared to him, and that no constructive dividend may be imputed to him. The desire for such a use of corporate funds—a redemption by the corporation free of dividend tax dangers to the continuing stockholder—brought about the transactions in two recent cases.

In one decision,[2] the remaining shareholder made a contract to purchase the shares of the other stockholder. Unable to perform due to a lack of funds, the remaining shareholder assigned his contract to a third party. The third party purchased the shares from the retiring shareholder, and they were subsequently redeemed by the corporation from the third party. The Commissioner argued that the effect of these transactions constituted a constructive dividend to the remaining shareholder. The grounds were that the

[1] A simple illustration shows the economics of the situation: *X* and *Y* each own fifty per cent of the corporation, and they agree that on the death of either, the remaining shareholder will purchase the other's stock for $50,000, the fair market value of the stock at the time of the agreement. When *Y* dies, the corporation is worth $200,000. Assuming that *X* is in the fifty per cent tax bracket, he will have to declare a dividend of $100,000 from the corporation to himself in order to obtain the purchase price of $50,000. This would leave *X* with a corporation worth $100,000. However, if a redemption is provided for, the corporation will pay $50,000 and *X* will then be the sole owner of a corporation worth $150,000.

[2] Milton F. Priester, 38 T.C. 316 (1962).

corporation had satisfied the remaining shareholder's obligation to purchase the stock, and that the third party was merely used as a "straw man" to effect this purpose. Rejecting this line of reasoning, the Tax Court held that there was no constructive dividend. The third party was not merely a "straw"; rather, the facts indicated that he was an independent businessman acting for his own interests.[3]

The taxpayer was not as fortunate in another instance.[4] There the remaining shareholder also contracted to purchase the retiring shareholder's interest. Through necessity, or choice, the taxpayer borrowed money from the corporation and made the purchase himself. The shares were subsequently redeemed from the remaining stockholder, the consideration being a cancellation of his debt to the corporation.[5] It was held that the discharge of the debt was essentially equivalent to a dividend to the extent of available earnings and profits in the corporation.[6]

---

[3] *Id.* at 325.

[4] Aloysius McGinty, 38 T.C. 882 (1962).

[5] From a technical point of view, the continuing shareholder received a dividend by failing to come within the provisions of INT. REV. CODE OF 1954, § 302 which allows certain redemptions to be treated as capital exchanges rather than as dividends.

In Hargleroad v. United States, 202 F. Supp. 92 (D.C. Neb. 1962), the continuing shareholder received the shares from the retiring shareholder and had them redeemed himself. The court disregarded the circuitous means used to effect the redemption, and looked at the net effect of the transaction, construing that there was only a redemption and that there was no constructive dividend to the remaining shareholder. But compare Neff v. United States, 305 F.2d 455 (Ct. Cl. 1962) where a different approach was used. The sole shareholder had the corporation redeem his shares in order that the corporation could resell the shares and obtain additional working capital. On resale of the shares, the corporation made a large profit. But the court refused to look at the net effect of the transaction and held the redemption to be a dividend to the remaining shareholder because it failed to qualify under INT. REV. CODE OF 1954, § 302. The court felt that the business purpose involved was subservient to the code provisions which in effect provide that where a redemption of stock of a sole shareholder occurs, it will be considered a dividend to the extent of available corporate earnings and profits, rather than payment in exchange for the stock which would obtain sale or exchange treatment. In order to obtain sale or exchange treatment, the payments must meet the redemption qualifications in INT. REV. CODE OF 1954, § 302. If not, the payment will be treated as a dividend under INT. REV. CODE OF 1954, §§ 301(c), 316(a).

[6] The 1954 Code treats disbursements to the retiring shareholders fairly explicitly, however, there are no express provisions concerning the taxability of the remaining shareholders where the corporation redeems the shares of a retiring stockholder. Case law has developed in this field under INT. REV. CODE OF 1939, § 115(g) and subsequently under INT. REV. CODE OF 1954, § 302(b)(1). Under those provisions, the question is this: "Was the pay-

The historical development of the law in regard to the continuing shareholder's liability for a constructive dividend can be traced in the following manner:

The first group of cases concerned facts similar to those involved in the *McGinty* case.[7] The rule was established that where corporate funds were used to satisfy the remaining shareholder's *obligation* to purchase, then he would be deemed to have received the equivalent of a taxable dividend.[8]

The next important case involved an individual who had an *option* to purchase the remaining shares of a corporation in which he had a substantial interest.[9] He assigned his option to the corporation and the shares were redeemed. The Tax Court held that this was clearly a constructive dividend to the taxpayer because no corporate purpose was served and because the net effect was that the corporation made the purchase for the remaining shareholder. This ruling was reversed on appeal.[10] The taxpayer was never

ment to the retiring shareholder 'essentially equivalent to a dividend' to the remaining shareholder?" See Graham, *Redemption Problems: The Holsey and Zipp Cases,* 36 TAXES 925 (1958).

[7] See note 4 *supra* and accompanying text.

[8] Two of the leading cases establishing liability for constructive dividends where the corporation assumes the taxpayer's obligation to purchase are Wall v. United States, 164 F.2d 462 (4th Cir. 1947) and Thomas J. French, 26 T.C. 263 (1956). In the *Wall* case the taxpayer had given notes to purchase shares in the corporation. He surrendered the stock to the corporation and the corporation agreed to pay the note. In *French,* the taxpayer borrowed money from the corporation itself. He subsequently surrendered part of the stock and the corporation cancelled the outstanding debt. In both cases it was held that the satisfaction of the taxpayer's obligation was essentially the equivalent of a taxable dividend. See also, Zipp v. Commissioner, 259 F.2d 119 (6th Cir. 1958); Ferro v. Commissioner, 242 F.2d 838 (3d Cir. 1957); Woodworth v. Commissioner, 218 F.2d 719 (6th Cir. 1955); Lowenthal v. Commissioner, 169 F.2d 694 (7th Cir. 1948); Edgar S. Idol, 38 T.C. 444 (1962); George M. Hancock, 18 T.C. 210 (1952).

[9] Holsey v. Commissioner, 28 T.C. 962 (1957), *rev'd,* 258 F.2d 865 (3d Cir. 1958). For a discussion of this case and subsequent revenue rulings, see Ward v. Rountree, 193 F. Supp. 154 (M.D. Tenn. 1961), where two shareholders each owned fifty per cent of two different corporations. One corporation redeemed the stock of one shareholder, and the other corporation redeemed the shares of the other shareholder. It was held that the remaining shareholder(s) did not receive a constructive dividend as a result of the redemption(s).

[10] Holsey v. Commissioner, 258 F.2d 865, 869 (3d Cir. 1958). The court disregarded the arguments as to whether there had been a business purpose for the redemption. It was stated that the effect of the redemption rather than its purpose was the controlling factor in determining whether the redemption was equivalent to a dividend.

"obligated" to purchase the shares and the shares never came into his possession. Therefore, there was a straight redemption and no constructive dividend to the remaining shareholder.[11] The Commissioner agreed to follow this decision.[12]

A subsequent revenue ruling seems to depart somewhat from the "obligation" test.[13] The taxpayer was obligated either to purchase the shares or to vote his stock for liquidation of the corporation. Instead of pursuing either alternative under the contract, the shareholder caused the corporation to redeem the shares for book value and for a valid business purpose. It would seem that the corporation had clearly satisfied the continuing shareholder's obligation (and certainly the corporation expended funds to render that obligation moot), but it was ruled that there was no constructive dividend. The "obligation" cases were distinguished because here the taxpayer never bought the shares for himself, nor did he obligate himself to do so, except in the alternative. In the prior "obligation" cases, the shareholder had either actually purchased the shares before the corporation redeemed, or he was obligated to do so without express reference to any corporate redemption.

It is apparent that the decided cases put a premium on the drafting of the agreement. If the parties provide for corporate redemption, the continuing shareholder is saved from the constructive dividend, because he was at no time obligated to purchase the shares.[14]

[11] Ray Edenfield, 19 T.C. 13 (1952), is another example of an unsuccessful attack by the Commissioner where the taxpayer was not obligated to purchase the shares. The taxpayers bought a portion of the retiring shareholder's stock and had the corporation issue its notes to the retiring shareholder in redemption of the remainder of the stock. The Commissioner argued that when the notes were paid off, the remaining shareholders received the equivalent of a dividend, because the corporation was paying the debt *for* the remaining shareholders. The court did not follow this theory because the debt was solely that of the corporation. The continuing shareholder was never obligated.

[12] Rev. Rul. 58-614, 1958-2 Cum. Bull. 920. The ruling warns that if the stock is surrendered to the corporation for less or more than fair market value, it may be treated as a gift to or from the retiring shareholder.

[13] Rev. Rul. 59-286, 1959-2 Cum. Bull. 103.

[14] The remaining shareholder may not want the working capital of the corporation to be diminished by the redemption cost. In such a case, he could take over the corporation's obligation to purchase the stock, since the retiring shareholder probably would not object. There is, however, some danger in this approach. The redemption price could be less than the fair market value of the stock. When the corporation assigns the contract to the shareholder who is to remain, what will be the result? No case law concerning this type arrangement has been found. The assignment could be

The same result could be obtained if the corporation were obligated to purchase the shares, contingent on the continuing shareholder's not having previously exercised an option to buy the shares for himself.[15] This agreement would be more flexible in that the remaining shareholder could use either his own or corporate funds. Thus the shareholder's needs and the needs of the corporation at the time of redemption or purchase could both be considered in determining which course to follow.

It seems questionable that the continuing shareholder should ever be taxed as having received a constructive dividend where the action taken has the same effect as a straight redemption. Since redemptions are allowed, it is somewhat unjust to penalize a shareholder who discovers, after he has obligated himself, that he would be better off having the corporation redeem. Also, the whole theory behind the "obligation" cases seems somewhat illogical. If a shareholder's *obligation* to purchase is assigned to a third party, the shareholder would never be taxed for the *benefits* accruing to that third party as a result of the assignment. Admittedly, the result in such an instance may differ where the assignment is made to the corporation, in that the assignor receives the benefits of the contract because he becomes the sole owner of the corporation. But this is not the complete consequence. The corporation which the remaining shareholder now owns in its entirety is diminished by the amount of the redemption price.[16] When the shareholder makes the assignment, he not only assigns his obligation, but he also assigns the benefits which would otherwise flow to him. Since there has been a loss of benefit as well as obligation, why should there be a constructive dividend?[17]

---

treated as a gift to the remaining shareholder of the excess over fair market value. But this possible threat might be avoided by allowing the corporation to redeem and by contributing more capital at the time of redemption.

[15] This clause in the agreement should be very carefully worded in order to avoid the construction that the shareholder was obligated to purchase the shares. For instance, the following type clause should be avoided: "At such time, the remaining shareholder will purchase, or the corporation will redeem, such shares."

[16] Assume X and Y are equal shareholders in a corporation whose shares are worth $200,000. If X buys the shares, he becomes the sole owner of a corporation valued at $200,000. On the other hand, if the corporation redeems Y's stock for $100,000, then X becomes the sole owner of a corporation worth only $100,000.

[17] Erickson v. United States, 189 F. Supp. 521 (S.D. Ill. 1960) lends support to this argument. In this case, the obligation theory was not followed.

Moreover, if the continuing shareholder is to be taxed at all, as having received a constructive dividend, why should the results be dependent on whether the shareholder "obligated" himself to buy the shares? For policy reasons, some sort of "business purpose" test would seem more consistent. For example, it would seem logical to tax the continuing shareholder where the corporation had a real need for working capital but nevertheless used the needed funds to redeem at a price which was no bargain, for the sole purpose of accommodating the remaining shareholder. On the other hand, it would seem illogical to tax the continuing shareholder when the corporation had excessive funds on hand to use for redemption at a price which was a bargain. Under the obligation test, however, these factors would not be considered.

Under the present state of the law, it seems unlikely that the Commissioner will attack again where there is no obligation on the remaining shareholder to purchase the shares, regardless of whether there was any business purpose whatever for the redemption. It would seem even more unlikely that the courts would rule for the Commissioner should he take such action. Until some change is effected concerning the "obligation" theory, the drafters of the purchase or redemption contract should beware the constructive dividend.

JOHN SIKES JOHNSTON

The stockholder borrowed money from a third party to purchase the shares from the estate of a deceased shareholder, in agreement with the other remaining shareholders. The corporation, when it became financially able, paid off the stockholder's debt to the third party and cancelled the shares. Although it would seem that the shareholder's obligation was satisfied, it was held that there was no dividend. The court stated that in reality there had been merely a redemption by the corporation from the deceased shareholder's estate. The form of the transaction was regarded as being merely a temporary expedient which would enable the corporation to retire the shares without overextending its financial position at the time.

The taxpayer in effect assigned his benefits under the contract, as well as his obligation, to the corporation. Consequently, he received no constructive dividend.

If the continuing shareholder were never taxed on a constructive dividend where the net effect of the transaction was that of a redemption, the substance of the transaction would be controlling, rather than its form.

Price Discrimination—Section 2(c) of the Robinson-Patman Act—The Liberation of the Functional Intermediary

The genesis of section 2(c),[1] the "brokerage clause" of the Robinson-Patman Act,[2] lay in the conviction that the mass purchasing power of large chain stores was being employed to coerce from suppliers the payment of brokerage or extension of discounts in lieu of brokerage which were not earned due to the absence of performance of any brokerage service by these direct buying purchasers.[3] It was feared that such "dummy brokerage" would drive the small buyer, who was unable to obtain these illusory payments from a seller, to economic extinction. Recent judicial and administrative interpretations have worked at least a partial metamorphosis in the status of this section[4] which at one time was considered to be the most settled area of this notoriously unsettled statute.[5]

Section 2(a),[6] the general "price discrimination" provision of

[1] 49 Stat. 1527 (1936), 15 U.S.C. § 13(b) (1958). Section 2(c) declares it to be unlawful for "any person ... to pay or grant, or to receive or accept, anything of value as a commission, brokerage, or other compensation, or any allowance or discount in lieu thereof, except for services rendered in connection with the sale or purchase of goods ... either to the other party to such transaction or to an agent ... or other intermediary therein where such intermediary is acting in ... behalf ... of any party to such transaction other than the person by whom such compensation is so granted or paid."

[2] The Robinson-Patman Act, the "price discrimination law," amends § 2 of the Clayton Act, 38 Stat. 730 (1914).

[3] See FINAL REPORT OF THE CHAIN STORE INVESTIGATION, S. Doc. No. 4, 74th Cong., 1st Sess. 85 (1935); H.R. REP. No. 2287, 74th Cong., 2d Sess. 7 (1936); S. REP. No. 1502, 74th Cong., 2d Sess. 7 (1936); 80th CONG. REC. 3114, 3116, 6281 (1936) (remarks by Senator Logan). On the legislative background of § 2(c) see ROWE, PRICE DISCRIMINATION UNDER THE ROBINSON-PATMAN ACT 332-37 (1962); Oppenheim, *Administration of the Brokerage Provision of the Robinson-Patman Act*, 8 GEO. WASH. L. REV. 511, 516-20 (1940).

[4] See FTC v. Henry Broch & Co., 363 U.S. 166 (1960); Thomasville Chair Co. v. FTC, 306 F.2d 541 (5th Cir. 1962); Edward Joseph Hruby, TRADE REG. REP. ¶ 16225 (FTC Dkt. 8068, 1963).

[5] Prior to the revolution in the construction of § 2(c), one commentator had said: "Section 2(c) is undoubtedly the most ambiguous and faultily drafted section of the Act. Yet, surprisingly enough, it is the only section as to which no important question of interpretation still remains unsettled." AUSTIN, PRICE DISCRIMINATION AND RELATED PROBLEMS UNDER THE ROBINSON-PATMAN ACT 106 (2d rev. ed. 1959).

changed, this would seem an insufficient reason to grant appraisal rights as

[6] 49 Stat. 1526, 15 U.S.C. § 13(a) (1958). Section 2(a) provides: "That it shall be unlawful ... to discriminate in price between different purchasers of commodities of like grade and quality ... where the effect of such discrim-

the act, requires for an actionable violation both a discrimination in price[7] and a resulting competitive injury.[8] Prima facie violations are subject *inter alia* to the defenses of (1) "cost justification,"[9] based on a showing that the lower price was justified by lower costs of manufacture, sale or delivery and (2) a good faith meeting of a competitor's price.[10] In contrast with section 2(a), section 2(c) was deemed to unqualifiedly prohibit receipt of payments by a buyer or his agent from a seller, thus eliminating the possibility of employing any of the defenses which section 2(a) provides,[11] and making such payments per se illegal.[12] The section contains one possible qualification, the "except for services rendered" clause, which seemed to present a defense to an illegal brokerage charge. This qualification,

---

ination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them: *Provided,* That nothing herein contained shall prevent differentials which make only due allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered."

[7] FTC v. Anheuser-Busch, Inc., 363 U.S. 536 (1960); Atlas Bldg. Prod. Co. v. Diamond Block & Gravel Co., 269 F.2d 950 (10th Cir. 1959); *cert. denied,* 363 U.S. 843 (1960). For a thorough discussion of the conflicting views as to what constituted a price discrimination prior to the *Anheuser-Busch* case, see ROWE, PRICE DISCRIMINATION UNDER THE ROBINSON-PATMAN ACT 92-107 (1962).

[8] FTC v. Anheuser-Busch, Inc., *supra* note 7; FTC v. Morton Salt Co., 334 U.S. 37 (1948). These two cases contrast the differing requirements for "injury to competition" at the seller's level and the customer's level.

[9] See Automatic Canteen Co. v. FTC, 346 U.S. 61 (1953); Minneapolis-Honeywell Regulator Co. v. FTC, 191 F.2d 786 (7th Cir. 1951), *cert. dismissed,* 344 U.S. 206 (1952).

[10] This defense is derived from the § 2(b) proviso which declares: "That nothing herein contained shall prevent a seller rebutting the prima facie case thus made by showing that his lower price ... to any purchaser ... was made in good faith to meet an equally low price of a competitor." 49 Stat. 1527 (1936), 15 U.S.C. § 13(b) (1958). This section has created much controversy as to the extent of the defense allowed therein, but it has been construed to give an absolute defense to a charge of price discrimination, even though there exists a competitive injury in the transaction under consideration.

[11] *E.g.,* FTC v. Washington Fish & Oyster Co., 271 F.2d 39 (9th Cir. 1959); Oliver Bros. v. FTC, 102 F.2d 763 (4th Cir. 1949); Southgate Brokerage Co. v. FTC, 150 F.2d 607 (4th Cir.), *cert. denied,* 326 U.S. 774 (1945).

[12] The words "other than brokerage" originally followed the words "differences in costs" in § 2(a), but they were stricken and this was construed to mean that § 2(c) was to be completely independent of § 2(a) with no § 2(a) defenses allowed. Biddle Purchasing Co. v. FTC, 96 F.2d 687 (2d Cir.), *cert. denied,* 305 U.S. 634 (1938).

however, was emasculated in the first cases to be presented to the courts charging a section 2(c) violation[13] by holding, in effect, that as a matter of law a buyer or his agent could not render any services to a seller.

Perhaps the harshest of the earlier section 2(c) decisions arose not in the context of a direct buying chain or an independent intermediary but in a case dealing with a "buying broker."[14] In *Southgate Brokerage Co. v. FTC*,[15] defendant company which did a large brokerage business also purchased goods on its own account, reselling to wholesalers who paid the same price to the seller that they would have paid had they purchased through a broker. On its direct purchases Southgate received by way of discount the same commission which it received in its brokerage operations. Again it was held that under no circumstances could a buyer "render services" to a seller.[16] The court further emphasized that lack of discriminatory effect among buyers was wholly irrelevant due to the independence of sections 2(a) and 2(c).[17]

Because violations of section 2(c) were interpreted to be illegal per se, it became a prime target for critics of the Robinson-Patman Act.[18] The most repeated charge was that it fostered "soft compe-

[13] Webb-Crawford Co. v. FTC, 109 F.2d 268 (5th Cir. 1940); Great Atl. & Pac. Tea Co. v. FTC, 106 F.2d 667 (3d Cir. 1939), *cert. denied*, 308 U.S. 625 (1940); Oliver Bros. v. FTC, 102 F.2d 763 (4th Cir. 1939); Biddle Purchasing Co. v. FTC, *supra* note 12. The rationale of these cases is that true brokerage services can be rendered only by an agent of the party paying the fee, and that consequently a buying and selling service cannot be rendered by the same party in the same transaction. Thus when a brokerage fee reaches the buyer, it is nothing more than a rebate or discount in price. The basis of this rationale is grounded on the theory that the seller strives to sell at the highest possible price and the buyer to buy at the lowest—clearly neither is in any way attempting to render a service to the other.

[14] The term "buying broker" is used to denote an intermediary who, in addition to acting as a "pure" broker, buys goods for his own account, taking title to them and assuming all risks commensurate thereto. This type of activity is particularly prevalent in the South where the "buying broker" resells as a distributor to low volume wholesalers or small retailers, neither of which have the requirements or credit status to enable them to directly buy substantial quantities. This mode of distribution has also been utilized to a great extent by packers of fish products. See generally EDWARDS, THE PRICE DISCRIMINATION LAW 140-47 (1959).

[15] 150 F.2d 607 (4th Cir.), *cert denied*, 326 U.S. 774 (1945).

[16] *Accord, In re* Whitney & Co., 273 F.2d 211 (9th Cir. 1959).

[17] *Accord*, FTC v. Washington Fish & Oyster Co., 271 F.2d 39 (9th Cir. 1959).

[18] See EDWARDS, THE PRICE DISCRIMINATION LAW 150-52 (1959); ROWE, PRICE DISCRIMINATION UNDER THE ROBINSON-PATMAN ACT 539 (1962);

tition"[19] and created an island of immunity for independent brokers in that they had a monopoly in their distributive function. The effect was a legal disqualification of all but the "pure" broker's services resulting in an inhibition of new distributional methods[20] and actually placing the Robinson-Patman Act at odds with the broader antitrust objective of vigorous competition.[21] Recommendations for remedial action[22] ranged from complete legislative repeal of the section and allowance of this area to be treated under section 2(a)[23] to judicial overruling of the past precedents, based on a more perceptive approach to the realities of business.[24]

Adleman, *Effective Competition and the Antitrust Laws,* 61 HARV. L. REV. 1289, 1335-37 (1948); Kelly, *Functional Discounts under the Robinson-Patman Act,* 40 CALIF. L. REV. 526, 553 (1952); Oppenheim, *Administration of the Brokerage Provision of the Robinson-Patman Act,* 8 GEO. WASH. L. REV. 511, 536-40 (1940).

[19] ROWE, *op. cit. supra* note 18, at 539-40; Oppenheim, *Federal Antitrust Legislation: Guideposts to a Revised National Antitrust Policy,* 50 MICH. L. REV. 1139, 1207 (1952).

[20] *E.g.,* Southgate Brokerage Co. v. FTC, 150 F.2d 607 (4th Cir.), *cert. denied,* 326 U.S. 774 (1945). Disallowance of discounts to the distributor in that case, as payments in lieu of brokerage, would lead one to conclude that the field of distributional intermediaries was forever pre-empted by the traditional wholesaler, jobber, and independent broker. This conclusion has happily had its foundations shaken by Edward Joseph Hruby, TRADE REG. REP. ¶ 16225 (FTC Dkt. 8068, 1963).

[21] See ATT'Y GEN. NAT'L COMM. ANTITRUST REP. 190-93 (1955). This report emphasized that the essence of antitrust policy in distribution is to insure that the consumer benefits by vigorous competition along each step of the way. Yet, it noted, § 2(c) as then interpreted invalidated the genuine functions performed by business men who had invested capital and services in the middleman's phase of the marketing process unless they were "independent" brokers. This clogged competition in the channels of distribution by the creation of a legal monopoly for the "independent" broker.

[22] One writer has exculpated the Commission and the courts for their interpretations of the brokerage clause on the ground that they have followed the Congressional intent to the letter. 100 U. PA. L. REV. 107, 118 (1951). However, Rowe takes a contrary stand in that the Commission has in the "run-of-the-mine" § 2(c) case "hoisted puny respondents from the back waters of business," rather than pursuing mass purchasing, direct buying, firms of national stature, which were originally the targets of the section's restrictions. ROWE, PRICE DISCRIMINATION UNDER THE ROBINSON-PATMAN ACT 539-40 (1962).

[23] EDWARDS, THE PRICE DISCRIMINATION LAW 643-45 (1959); ATT'Y GEN. NAT'L COMM. ANTITRUST REP. 192-93 (1955); Oppenheim, *Federal Antitrust Legislation: Guideposts to a Revised National Antitrust Policy,* 50 MICH. L. REV. 1139, 1206-07 (1952). The Attorney General's Committee's recommendation for legislative change was based on the fact that it deemed judicial reconsideration impossible due to numerous appellate adjudications which affirmed the Commission's previous restrictive holdings.

[24] See ROWE, PRICE DISCRIMINATION UNDER THE ROBINSON-PATMAN

After years of conscientious enforcement of section 2(c) and unanimity of interpretation by the Commission and the lower courts, what ultimately has proved to be the first breakthrough in the per se construction of section 2(c) came in the 1960 decision of *FTC v. Henry Broch & Co.*,[25] the first section 2(c) case to reach the Supreme Court. There an independent broker reduced his fee to a supplier in order to enable the supplier to meet the buyer's offered price. In a five to four decision the court held that section 2(c) applied under these circumstances[26] and that the reduction in price amounted to an allowance in lieu of brokerage. In the course of the opinion the court stated:

> This is not to say that every reduction in price coupled with a reduction in brokerage automatically compels the conclusion that an allowance "in lieu" of brokerage has been granted. Whether such a reduction is tantamount to a *discriminatory* payment of brokerage depends on the circumstances of each case.[27]

The court held that this reduction in brokerage was made to obtain the particular order involved and, therefore, was discriminatory.[28] The thread of qualifying language running throughout the majority opinion provoked the dissent into concluding that the majority had created a fusion between section 2(a) and section 2(c)

ACT ch. 17 (1962), for a comprehensive comment on the administration of the Act where he recommends a judicial harmonization of the Robinson-Patman Act and the antitrust laws via a more flexible approach by the courts and a "quarantine" of the absolute liabilities of the brokerage provision. *Cf.*, Edwards, Book Review, 111 U. PA. L. REV. 258 (1962).

[25] 363 U.S. 166 (1960).

[26] The dissent was of the opinion that § 2(c) did not apply to this transaction because it did not in any way involve a payment or allowance for services claimed to have been performed by the buyer or his intermediary. It was felt that the reduction involved should be tested under § 2(a) thereby permitting it to be cost justified. *Id.* at 182-84.

[27] *Id.* at 175-76. (Emphasis added).

[28] It is important to note that the majority expressly disclaimed any fusion of §§ 2(a) and 2(c) in requiring a "discrimination" before a reduction in price in brokerage coupled with a reduction in price would compel the conclusion that there had been an allowance in lieu of brokerage. *Id.* at 176. The dissenting commissioner in Edward Joseph Hruby, TRADE REG. REP. ¶ 16225 (FTC Dkt. 8068, 1963) apparently agreed with this disclaimer in arriving at his conclusion that §§ 2(c) and 2(a) were not fused as a result of the dictum in *Broch*. He was of the opinion that the only purpose that the *Broch* majority had in pointing out that the reduction in commission was there effectuated to obtain that particular order, was merely to emphasize the fact that there was "an allowance in lieu of brokerage."

thereby weakening the per se thrust that Congress had intended that section 2(c) should have.[29]

The dissenters in *Broch* proved to be prophetic, for in *Thomasville Chair Co. v. FTC*[30] the Court of Appeals for the Fifth Circuit seized upon that conditioning dictum of the *Broch* majority to further enfeeble the per se illegality approach to section 2(c). There a furniture manufacturer classified its customers into two accounts. The jobber accounts consisted of those who purchased at least 50,000 dollars worth of merchandise a year while those who bought less than that amount were classified as carload accounts. Over a period of some thirty-five years the jobber accounts had received an over-all five per cent discount from the price paid by the carload accounts. This discount was due partly to the fact that salesmen's commissions were three per cent less on jobber accounts than on carload accounts. The court held that the Commission was in error in holding that a reduction in price coupled with a reduction in commissions was a conclusive violation of section 2(c) unless the entire five per cent reduction could be justified by a cost savings exclusive of the commission differential.[31] It was concluded that in addition to inquiring into the matter of correct customer classification,[32] the Commission should consider whether the difference in commission rates was justified by savings in costs *to the salesmen* in selling to

[29] The dissent was not alone in this conclusion, for several writers commented upon the possible unsettling effects that the language of the majority might have on the past § 2(c) interpretation. See ROWE, PRICE DISCRIMINATION UNDER THE ROBINSON-PATMAN ACT 331, 344-45 (1962); Michael, *Brokerage and the Robinson-Patman Act*, 10 LOYOLA L. REV. 165, 175 (1960-61); 46 IOWA L. REV. 700 (1961); 13 STAN. L. REV. 133 (1960).

[30] 306 F.2d 541 (5th Cir. 1962); 43 B.U.L. REV. 427 (1963); 51 CALIF. L. REV. 215 (1963).

[31] See Thomasville Chair Co., 55 FTC 2076, 2077 (1959). The Commission had based its opinion on well-engrained precedent in citing Great Atl. & Pac. Tea Co. v. FTC, 106 F.2d 667 (3d Cir. 1939), *cert. denied*, 308 U.S. 625 (1940); Oliver Bros. v. FTC, 102 F.2d 763 (4th Cir. 1939); Biddle Purchasing Co. v. FTC, 96 F.2d 687 (2d Cir.), *cert. denied*, 305 U.S. 634 (1938).

[32] The "quantity discount" given here to the larger volume customers is an approved method of differentiating prices charged, if such price differences can be cost-justified. The discount brackets into which customers are placed must be neither unreasonably broad nor unrelated to cost savings attributable to the size of shipments and must further be actually available to all customers. See Bruce's Juices, Inc. v. American Can Co., 87 F. Supp. 985 (S.D. Fla. 1949), *aff'd*, 187 F.2d 919 (5th Cir.), *cert. dismissed*, 342 U.S. 875 (1951).

jobber customers. To substantiate this conslusion the court relied heavily on the *Broch* dictum and stated:

> [A]s we read it, the court's opinion [in *Broch*] says that a reduction in price, giving effect to reduced commissions paid by the seller are violations of section 2(c) only if such reduction in price is "discriminatory." We read this to mean "without justification based on bona fide differences in the costs of sales resulting from the differing methods or quantities in which such commodities are sold or delivered."[33]

Although done in a somewhat ambiguous manner, a court for the first time in a case involving section 2(c) required a finding of a "discrimination" and allowed the defense of cost-justification, both of which were heretofore applied exclusively to section 2(a) cases.[34]

The third leg of the "new 2(c)" approach made its appearance in the recent FTC proceedings against *Edward Joseph Hruby*.[35] The facts of this case are essentially the same as those in *Southgate*. Like the respondent there, Hruby acted in some transactions as a broker, while in others he purchased goods on his own account. The initial order charged Hruby with receipt of allowances in lieu of brokerage;[36] however, the Commission ruled that his operations placed him at a functional level midway between the producer of the goods and the wholesalers to whom he sold. The lower price that he received reflected not a saving in brokerage, but rather the difference in the

[33] 306 F.2d at 545. In FTC v. Anheuser-Busch, Inc., 363 U.S. 536 (1960), the Supreme Court held that a mere price differential was tantamount to a "price discrimination." However, in the quoted language here the circuit court seems to be at variance with the Supreme Court's definition in that it has synonymized lack of discrimination with the defense of cost justification.

[34] The Commission has announced its non-acquiescense in *Thomasville Chair* and has stated that it now reads the decision "as holding that the Commission, in a case in which it is alleged that a seller has violated § 2(c) of the Clayton Act by passing on a reduction in brokerage to favored buyers in the form of a discriminatory price reduction, may not rely solely on the fact that the seller has paid less brokerage on the sales at the lower price, but must establish a causal relationship between the reduced brokerage and the reduced sales price. The Commission does not, however, acquiese in the opinion of the Court of Appeals as such, which contains dicta with which the Commission does not necessarily agree. Since the Commission does not believe that the public interest would be advanced by a further proceeding to establish whether respondent has violated § 2(c), the complaint must be dismissed." BNA ANTITRUST TRADE REG. REP. A-11 (No. 120 Oct. 29, 1963).

[35] Edward Joseph Hruby, TRADE REG. REP. ¶ 16225 (FTC Dkt. 8068, 1963) (order dismissing the complaint).

[36] Edward Joseph Hruby, TRADE REG. REP. ¶ 15709 (FTC Dkt. 8068, 1962).

functional-competitive level at which he and his wholesaler customers operated. Being at a higher functional level than the wholesaler he received no more than the familiar functional discount,[37] which does not violate the Robinson-Patman Act in absence of a discrimination with an accompanying anti-competitive effect.[38] Although Commissioner Elman, writing for the majority, made no mention of *Southgate,* Commissioner McIntyre in his dissent was quick to point out that this case was on all fours with *Southgate,*[39] that the economic justification for such reduction in price had been answered negatively in *Southgate,*[40] and that by refusing to follow that decision the Com-

[37] Sellers who market their products through numerous channels normally classify buyers as to the distributional function performed; consequently, prices to these classes, traditionally ranging from retailers through jobbers to wholesalers, are scaled in accordance with the functions discharged by each of the groups. For extensive discussion of functional discounts see Kelly, *Functional Discounts under the Robinson-Patman Act,* 40 CALIF. L. REV. 526 (1952). The author notes that functional discounts are not mentioned in the Robinson-Patman Act by name, which leads to the assumption that their validity will depend not on their characterization as such, but on the prohibitive effect of the legislation on price discrimination in general. *Id.* at 529. They are, therefore, subjected to the same tests as other price differences, in determining whether or not they amount to an unlawful discrimination in price. See FTC v. Ruberoid Co., 343 U.S. 470 (1952); Standard Motor Prod., Inc. v. FTC, 265 F.2d 674 (2d Cir.), *cert. denied,* 361 U.S. 826 (1959). Usually there will be an absence of any competitive relationship among those at the different functional levels, thereby precluding the possibility of a price discrimination. However, even where an active discrimination is established, the defense of cost-justification will be available to the party charged therewith, if the functional discounts correctly reflect such cost savings.

[38] Minneapolis-Honeywell Regulator Co. v. FTC, 191 F.2d 786 (7th Cir. 1951), *cert. dismissed,* 344 U.S. 206 (1952).

[39] Edward Joseph Hruby, TRADE REG. REP. ¶ 16225 at 21054 (FCT Dkt. 8068, 1963).

[40] Actually the respondent in *Southgate* did not base his economic justification on the fact that as a distributor he warranted a functional discount. Rather he took the position that since he performed the same services as a broker, he was entitled to the compensation of a broker. 105 F.2d at 611. The suggestion has subsequently been made that perhaps he sealed his doom by calling the allowance that he received "brokerage." If the parties to the sales of goods had exercised their semantical ingenuity and labelled the allowance a "distributor's discount," it very possibly would have been adjudged lawful in that it would have fallen under § 2(a) and thus qualified as a functional discount. AUSTERN, CCH ROBINSON-PATMAN ACT SYMPOSIUM 45 n.41 (1946); 100 U. PA. L. REV. 107, 117 (1951). *Cf., In re* Whitney & Co., 273 F.2d 211, 215 (9th Cir. 1959). In *Hruby* the respondent's suppliers described the payments or discounts granted to him as "brokerage" or "discounts in lieu of brokerage." The majority found that these payments, despite their labels, were in fact functional discounts designed to permit Hruby to resell to wholesalers and were not barred by § 2(c). TRADE REG. REP. ¶ 16225 at 21051 (FTC Dkt. 8068, 1963).

mission had in effect fused sections 2(c) and 2(a).[41]

The graphic appraisal of the economic exigencies made by the majority in *Hruby*[42] is the approach that commentators have pleaded for since the creation of the *Southgate* doctrine.[43] In particular it places the "buying broker" under the general price discrimination provisions of section 2(a) and removes him from the more restrictive section 2(c) area.[44] This is a welcomed consequence for it will allow intermediaries and distributors of the less conventional type to solidify their place in the marketing structure, their functional utility now having been recognized and legally approved. In general it seems to push wider the already open door in allowing section 2(a) principles to be applied to section 2(c) violations and thus extending the *Broch-Thomasville Chair* "new 2(c)" construction. Those who have maintained that the older rulings and decisions limited the growth of intermediary functions by giving the independent broker the preferred position in the distributional hierarchy may now point to this triumvirate of cases as at least partially reversing the former disqualifying effect.

One possible argument against interpreting *Hruby* as furthering

[41] The dissenter in his enthusiasm to criticize the majority's fusion of §§ 2(c) and 2(a) seems to have overlooked (or purposely avoided) the *Thomasville Chair* decision which was handed down in August of 1962, some three months before the final order in *Hruby* was issued. Had this case been brought to his attention (assuming he innocently overlooked it), there might well have been no dissenting opinion.

[42] For another price discrimination case, involving problems totally unrelated to those in *Hruby,* in which Commissioner Elman in a losing cause took an equally pragmatic approach to the "conviction" of a major oil company involved in a gas price war, see American Oil Co., TRADE REG. REP. ¶ 15961 (FTC Dkt. 8183, 1962). However, the Commission's finding that American violated § 2(a) when it reduced prices during the seventeen day gas war to its dealers in one town without granting similar reductions to its dealers in an adjoining town was reversed where the evidence showed that the injury to competition was only minimal and temporary, and that any economic injury suffered by the nonfavored dealers was not attributable to price cuts by American, but to price reductions already in effect by other major brand gasoline suppliers. American Oil Co. v. FTC, TRADE REG. REP. (1963 Trade Cas.) ¶ 70948 (7th Cir. Nov. 19, 1963).

[43] See AUSTERN, CCH ROBINSON-PATMAN ACT SYMPOSIUM 45 n.41 (1946); AUSTIN, PRICE DISCRIMINATION AND RELATED PROBLEMS UNDER THE ROBINSON-PATMAN ACT 115 (1959); EDWARDS, THE PRICE DISCRIMINATION LAW 144-45 (1959); ROWE, PRICE DISCRIMINATION UNDER THE ROBINSON-PATMAN ACT 359 (1962); 100 U. PA. L. REV. 107, 117 (1951).

[44] This decision echoed precisely the suggestion of two well-versed Robinson-Patman Act lawyers. See AUSTERN, *op. cit. supra* note 42; AUSTIN, *op cit. supra* note 42.

the demise of section 2(c)'s per se illegality is that *Southgate* was "suspect in its inception."[45] A thoughtful analysis such as Commissioner Elman made in *Hruby* would seem to lead to the conclusion that distributors in the position of *Southgate* and *Hruby* should never have been placed under the canopy of section 2(c). Without the discount which this type of distributor receives he could not possibly remain in business because he is compelled to offer to his wholesaling customers a price that is competitive with that paid by them to suppliers who sell through brokers. So analyzed, the services rendered would qualify this intermediary for a functional discount.[46] This, of course, would mean that any violation of the Robinson-Patman Act occurring in dealings here would fall under section 2(a), not section 2(c), and that *Southgate* was incorrect in applying 2(c).[47]

It is evident from the foregoing discussion that the Hruby decision is capable of at least two interpretations. The first and more narrow is reached by reading the decision as the majority saw it—a 2(a) case involving trade or functional discounts, 2(c) having no application whatsoever.[48] A narrow interpretation is also reached by reading *Hruby* as an isolated decision, unrelated to the more orthodox types of section 2(c) cases, that is, those involving independent brokers and direct buyers and their agents.[49] However, a broader application is achieved by interpreting the holding as the

[45] As pointed out in the dissenting opinion in *Hruby*, this was one of the arguments put forth by respondent in his brief. Impliedly, at least, the majority must have agreed with the statement. TRADE REG. REP. ¶ 16225 at 21054 (FTC Dkt. 8068, 1963).

[46] *Id.* at 21050.

[47] The dissenting commissioner in *Hruby*, conceding for the sake of argument that §§ 2(a) and 2(c) were fused, maintained that the respondent had still violated the Act inasmuch as he had made sales not just to wholesalers but also to direct buying chain stores. These sales to chains, he argued, created a price discrimination under § 2(a) because small retailers in competition with these large, direct buying, retailers bought from wholesalers who received no "discount in lieu of brokerage." *Id.* at 21055. This argument is based solely on a factual discrepancy and has no bearing on the more important §§ 2(c)-2(a) junction aspects of the decision.

[48] *Id.* at 21052.

[49] This view would form the basis of an argument that the buying broker type of § 2(c) case is sui generis and, therefore, a merger of §§ 2(c) and 2(a) for this class does not necessarily mean that the same applies in other types of § 2(c) cases. However, the qualifying dictum of *Broch* and the decision in *Thomasville Chair* stand to rebut any such deduction.

dissent saw it—a fusion of sections 2(a) and 2(c).[50] If this be true, it would seem to be a part of the natural sequence created by *Broch* and continued by *Thomasville Chair* of judicially repealing section 2(c) as it was originally intended to be construed, which intent was followed until the recent coup d'etat. Assuming that sections 2(a) and 2(c) have been fused—and certainly this is a supportable position to take—immediately the question is raised of what will be the ultimate result of such fusion. For example, it is conceivable that as a part of this natural sequence section 2(b),[51] the "meeting competition" proviso, will also be united with section 2(c). This would seem to be a tenable prediction because section 2(b) is always applicable as a defense where a section 2(a) violation is charged,[52] and if section 2(a) is now to be read with section 2(c), it would seem to follow that so should section 2(b).

At first blush a potential criticism of the *Broch-Thomasville Chair-Hruby* rationale is that it impiously disregards the Congressional intent upon which section 2(c) is based, but the obvious answer to this is that the brokerage clause was enacted primarily to make illegal illusory and unearned brokerage payments and discounts in lieu thereof and not to so warp our economy as to stifle competition and produce conflicts with the broader antitrust principles embodied in the Sherman, Clayton and Federal Trade Commission Acts.[53] Against the backdrop of the recent decisions discussed here, it is likely that there will be an enlargement of the realistic pattern they have created, thereby giving legitimate distributional functions and services their deserved place in our economy without the ever

[50] TRADE REG. REP. ¶ 16225 at 21055 (FTC Dkt. 8068, 1963).

[51] 49 Stat. 1527 (1936), 15 U.S.C. § 13(b) (1958). For the pertinent part of this section, see note 10 *supra*, and for a general discussion of the intricacies involved in the application of § 2(b) to prima facie violations of the Act, see EDWARDS, THE PRICE DISCRIMINATION LAW ch. 17 (1959); ROWE, PRICE DISCRIMINATION UNDER THE ROBINSON-PATMAN ACT ch. 9 (1962); 66 YALE L. J. 935 (1957).

[52] See, *e.g.*, Samuel H. Moss, Inc. v. FTC, 148 F.2d 378 (2d Cir.), *cert. denied*, 326 U.S. 734 (1945).

[53] The case law, as it stands now, is in the process of judicially reconstructing § 2(c), which the Attorney General's Committee did not think was possible because of the unanimity of court decisions under the existing interpretations. See ATT'Y GEN. NAT'L COMM. ANTITRUST REP. 192-93 (1955). Although the committee's opinion has proved to be incorrect, it would seem that its recommendation for legislation in this area is still sound, due to the uncertainties that remain in the wake of the recent decisions.

lingering, ominous cloud of illegality under the Robinson-Patman Act.

JAMES M. TALLEY, JR.

Sales—Implied Warranty—Cigarette Manufacturer's Liability for Lung Cancer

Plaintiff's decedent initiated suit in the United States District Court for the Southern District of Florida to recover damages for personal injuries resulting from lung cancer allegedly incurred by smoking Lucky Strike cigarettes. Shortly thereafter, he died from this condition and this claim[1] was consolidated with another brought under the Florida wrongful death statute.[2] The district court submitted the case to the jury on theories of negligence and breach of implied warranty.[3] In addition to rendering a general verdict for defendant, the jury answered specific interrogatories[4] to the effect that the fatal lung cancer was proximately caused by the smoking of Lucky Strikes and that, as of the time of the discovery of the cancer, defendant could not by the reasonable application of human skill and foresight have known of the danger to users of his product. Judgment was entered for defendant, and on appeal the Fifth Circuit Court of Appeals affirmed,[5] holding defendant not liable as an in-

[1] Under Florida survival law, decedent's claim passed to the executor of his estate. FLA. STAT. ANN. § 45.11 (Supp. 1962).

[2] FLA. STAT. ANN. §§ 768.01, .02 (1959).

[3] The complaint asserted liability under six separate counts: breach of implied warranty; breach of express warranty; negligence; misrepresentation; battery; and violation of the Federal Food, Drug and Cosmetic Act, 52 Stat. 1040 (1938), as amended, 21 U.S.C. §§ 301-392 (1958), the Federal Trade Commission Act, 38 Stat. 717 (1914), as amended, 15 U.S.C. §§ 41-77 (1958), and the Florida Food, Drug and Cosmetic Act, FLA. STAT. ANN. § 500.01 (1962). The trial court directed verdict for defendant on all except the implied warranty and negligence counts.

[4] The questions submitted and answered were: "(1) Did the decedent Green have primary cancer in his left lung? [Answered, YES] .... (2) Was the cancer in his left lung the cause or one of the causes of his death? [Answered, YES] .... (3) Was the smoking of Lucky Strike cigarettes on the part of the decedent, Green, a proximate cause or one of the proximate causes of the development of cancer in his left lung? [Answered, YES] .... (4) Could the defendant on, or prior to, February 1, 1956, by the reasonable application of human skill and foresight have known that users of Lucky Strike cigarettes, such as the decedent Green would be endangered, by the inhalation of the main stream smoke from Lucky Strike cigarettes, of contracting cancer of the lung? [Answered, NO] ...." Green v. American Tobacco Co., 304 F.2d 70, 71-72 (5th Cir. 1962).

[5] Green v. American Tobacco Co., 304 F.2d 70 (5th Cir. 1962).

surer under implied warranty for those consequences of the use of his product "of which no developed human skill and foresight could afford knowledge."[6] Petition for re-hearing was granted[7] and the legal question of absolute liability[8] was certified to the Supreme Court of Florida.[9] That court found that the common law[10] of Florida did impose absolute liability under the conditions posited in the question for breach of the implied warranty of merchantability.[11] The knowledge of defendant, either actual or implied, of the hazard of his product was held to be immaterial under this theory.

Although this is the first time a plaintiff has succeeded at this stage of cancer litigation against a cigarette manufacturer,[12] the

[6] *Id.* at 76.

[7] 304 F.2d at 85.

[8] The question certified: "Does the law of Florida impose upon a manufacturer and distributor of cigarettes absolute liability, as for breach of implied warranty, for death caused by using such cigarettes from 1924 or 1925 until February 1, 1956, the cancer having developed prior to February 1, 1956, and the death occurring February 25, 1958, when the defendant manufacturer and distributor could not on, or prior to, February 1, 1956, by the reasonable application of human skill and foresight, have known that users of such cigarettes would be endangered by the inhalation of the main stream smoke from such cigarettes, of contracting cancer of the lung?" 304 F.2d at 86. Note that the question is phrased in terms of the "reasonable" application of human skill and foresight. This accords with the question as submitted to the jury, but seems to conflict with other language of the opinion. See note 7 *supra* and accompanying text. See also Comment, 63 COLUM. L. REV. 515, 530, n.77 (1963), noting the inconsistency and offering the possible explanation that where a product is for human consumption, "reasonable" application of skill is equivalent to the absolute standard of the law of implied warranty. *Cf.* Gottsdanker v. Cutter Labs., 182 Cal. App. 2d 602, 6 Cal. Rep. 320 (Dist. Ct. App. 1960).

[9] Pursuant to statutory certification procedure. FLA. STAT. ANN. § 25.031 (1961).

[10] The Uniform Sales Act has not been adopted in Florida.

[11] Green v. American Tobacco Co., 154 So. 2d 169 (Fla. 1963).

[12] To date there have been six other decisions in cigarette-lung cancer litigation. In none has plaintiff recovered. Cooper v. R. J. Reynolds Tobacco Co., 158 F. Supp. 22 (D. Mass. 1957), *aff'd*, 256 F.2d 464 (1st Cir.), *cert. denied*, 358 U.S. 875 (1958), held that plaintiff was not in privity. Ross v. Phillip Morris Co., 164 F. Supp. 683 (W.D. Mo. 1958), *modified*, Civil No. 9494 (W.D. Mo. 1959), originally held that plaintiff was not in privity, but the decision was modified in light of the subsequent holding of the Missouri Supreme Court that privity is not required in Midwest Game Co. v. M.F.A. Milling Co., 320 S.W.2d 547 (Mo. Sup. Ct. 1959). In Pritchard v. Liggett & Myers Tobacco Co., 134 F. Supp. 829. (W.D. Pa. 1955), *rev'd*, 295 F.2d 292 (3d Cir. 1961), it was held that the evidence was sufficient for the jury on the questions of negligence, implied warranty, and express warranty. See note 36 *infra*. In Lartigue v. R. J. Reynolds Tobacco Co., 317 F.2d 19 (5th

holding of the Florida court merely represents the extension of familiar principles of law to a new class of products.[13] There is no novelty in the idea that a vendor's liability under the theory of implied warranty turns upon whether or not the product is *in fact* unmerchantable, rather than upon any consideration of defendant's knowledge or the general foreseeability of the hazard involved.[14] An otherwise qualified plaintiff is ordinarily able to make out his case upon a showing that his injury resulted from a defect in the product and that such defect was present when the product left the control of the manufacturer.[15] Thus, the holdings of the court in the instant case that "no reasonable distinction can . . . be made between the physical or practical impossibility"[16] of obtaining knowledge of the danger and that liability attaches where the product "is not in fact merchantable"[17] is not a surprising application of legal principles. In Florida, then, liability is strictly imposed upon a manufacturer for injuries caused by a substance in his product, the harmful propensities of which were hitherto unsuspected even when the substance is both common and natural to the entire generic class to which the

Cir. 1963), it was held that there is no warranty liability for unknowable hazards. See text accompanying note 23 *infra*. The remaining two cases, Padovani v. Bruchhausen, 293 F.2d 546 (2d Cir. 1961), and Mitchell v. American Tobacco Co., 183 F. Supp. 406 (M.D. Pa. 1960), are not germane to the present discussion.

[13] The principles are familiar in that Florida is one of an apparently increasing number of jurisdictions which does not require privity in the food cases. See RESTATEMENT (SECOND), TORTS, Explanatory Notes § 402A-1, 2 (Tent. Draft No. 7, 1962) (listing twenty-four such jurisdictions). See generally Prosser, *The Assault Upon the Citadel (Strict Liability to the Consumer)*, 69 YALE L.J. 1099, 1103-10 (1960). Although Dean Prosser's primary inquiry is into the problems posed by privity requirements, the importance of this article as a starting point in any research into general considerations of the law of implied warranty cannot be over-emphasized.

[14] See, *e.g.*, Pritchard v. Liggett & Myers Tobacco Co., 295 F.2d 292 (3d Cir. 1961); Brown v. Globe Labs., 165 Neb. 138, 84 N.W.2d 151 (1957); Henningsen v. Bloomfield Motors, Inc., 32 N.J. 358, 161 A.2d 69 (1960). See generally 1 FRUMER & FRIEDMAN, PRODUCTS LIABILITY § 16.01[1] (1963); Prosser, *The Implied Warranty of Merchantable Quality*, 27 MINN. L. REV. 117 (1943).

[15] Picker X-Ray Corp. v. General Motors Corp., 185 A.2d 919 (D.C. Mun. App. 1962); Athens Canning Co. v. Ballard, 365 S.W.2d 369 (Tex. Civ. App. 1963). See also Prosser, *The Implied Warranty of Merchantable Quality*, 27 MINN. L. REV. 117 (1943). The argument has been advanced, however, that imposition of such absolute and automatic liability in cases where the product cannot be made free from defects is at least subject to question. 1 FRUMER & FRIEDMAN, *op. cit. supra* note 14, at § 16.01[1].

[16] Green v. American Tobacco Co., 154 So. 2d 169, 171 (Fla. 1963).

[17] *Ibid.*

product belongs. It is to such products as these that we direct present attention; for here is a liability which, definitionally, is more stringent even than "liability without fault." It imposes liability for *deviation from the perfect* under circumstances in which perfection is a scientific impossibility.[18]

Reluctance to saddle a class of defendants with liability of such a nature could be expected and it is not surprising that much recent attention has been focused on the problem. Courts and writers have taken a new look at the rapidly expanding field of "products liability," particularly the warranty of merchantability, and have speculated as to whether its scope should be so broad as to impose liability for every imperfect product and whether such defenses as contributory negligence and assumption of the risk should be available to the manufacturer.

The answers proposed have been as diverse as their proponents, but there seems to be a strong feeling among most that the "warranty" is *not* one of perfection. Some argue that the warranty is founded upon the presumed intent of the parties to the sale and that it arises only because of the superior opportunity of the manufacturer to discover and remedy defects before they can cause injury. Under this view, they would find no liability for the carcinogens contained in cigarettes, since the manufacturer cannot be said to warrant against a totally unknown hazard.[19] Another argument is that strict liability exists only for the foreseeable risks attending the use of the product.[20] The Fifth Circuit has applied this "foreseeability" limi-

[18] Such liability may perhaps be justified in cases involving unexpected effects of new drugs such as the tranquillizer thalidomide, the use of which precipitated thousands of deformities in new-born infants. There would necessarily have to be a balancing of policy considerations militating *in favor* of liability as a deterrant to premature marketing of such products and *opposed* to its imposition on the theory that it would impede the development of new products on the part of a liability-conscious manufacturer. The "impediment to research" argument was rejected by the court in Gottsdanker v. Cutter Labs., 182 Cal. App. 2d 602, 6 Cal. Rep. 320 (Dist. Ct. App. 1960). See 9 WAYNE L. REV. 383, 389-90 (1963).

[19] This is the rationale employed by some courts in denying liability of a retail merchant for defective food in sealed containers. Scruggins v. Jones, 207 Ky. 636, 269 S.W. 743 (1925); Kroger Grocery Co. v. Lewelling, 165 Miss. 71, 145 So. 726 (1933). Williston argues that this view is opposed both to the weight of authority and general principles of the common law. 1 WILLISTON, SALES, § 242 (rev. ed. 1948).

[20] See generally Harper, *The Foreseeability Factor in the Law of Torts*, 7 NOTRE DAME LAW. 468 (1932); 9 WAYNE L. REV. 383 (1963).

tation in *Lartigue v. R. J. Reynolds Tobacco Co.*[21] There the court said: "[T]here must be a foreseeability of harm.... [The manufacturer] is an insurer against foreseeable risks—but not against *unknowable* risks."[22] Still others take the position that liability is limited to the harm which flows from the "contemplated use" of the product, and defendant can avoid liability by proving to the jury that plaintiff's use is excessive or otherwise "uncontemplated."[23]

There are other views, equally well thought-out,[24] but the great majority of them share in contemplating some limitation on liability

[21] 317 F.2d 19 (5th Cir. 1963). Construing Louisiana law, the court rejected defendant's contention that recovery of plaintiff, if any, must be based on the statutory warranty against redhibitory vices (hidden defects). 317 F.2d at 29. It was held that there was in addition to this statutory warranty another—of "wholesomeness"—implied by law, and that for breach of this warranty, strict delictual (tortious) liability attached. 317 F.2d at 30. The court found, however, that such liability had never been imposed even in the food cases in Louisiana except where harm was a foreseeable consequence of a defective condition. 317 F.2d at 35. It has been forcefully argued that such a test as this frees the manufacturer from warranty liability unless he is *negligent*. FRUMER & FRIEDMAN, *op. cit. supra* note 14, at § 16.03[4][a].

The *Lartigue* court quotes at length from the opinion which it rendered in the *Green* case; and the holdings are very nearly indistinguishable. Both apparently assume that the applicable warranty was breached, but condition the resultant liability upon "knowledge of consequences" (*Green*) or "foreseeability of harm" (*Lartigue*).

[22] 317 F.2d at 36-37.

[23] Nelson v. Union Wire Rope Corp., 39 Ill. App. 2d 73, 187 N.E.2d 425 (1963) (material hoist used to carry passengers); Vincent v. Nicholas E. Tsiknas Co., 337 Mass. 726, 151 N.E.2d 263 (1958) (beer can opener used on glass jar). See also Weston, *Contributory Negligence in Product Liability*, 12 CLEV.-MAR. L. REV. 424 (1963); Bushnell, *Illusory Defense of Contributory Negligence in Product Liability*, 12 CLEV.-MAR. L. REV. 412 (1963); 61 MICH. L. REV. 1180 (1963).

[24] A product may not be legally defective until science discovers the danger. Suggested in Dickerson, *The Basis of Strict Products Liability*, 16 FOOD DRUG COSM. L.J. 585, 594 (1961). Strict liability does not mean *strict* liability; the former differs from negligence only in that specific acts of negligence need not be proven, the latter is the kind imposed under workmen's compensation and is not applicable in this area. *Id.* at 592-93. Goods of first quality not required to satisfy the standard of "merchantability." 1 WILLISTON, SALES, § 243 (rev. ed. 1948). Warranty extends only to the "reasonable expectations" of consumer. DICKERSON, PRODUCTS LIABILITY AND THE FOOD CONSUMER, § 4.3 (1951). Substance not deleterious if "natural" to the product. Mix v. Ingersoll Candy Co., 6 Cal. 2d 674, 59 P.2d 144 (1936) (chicken bone in chicken pie); Brown v. Nebiker, 229 Iowa 1223, 296 N.W. 366 (1941) (sliver of pork bone in pork chop); Adams v. Great Atlantic & Pacific Tea Co., 251 N.C. 565, 112 S.E.2d 92 (1960) (crystallized corn kernel in corn flakes). See concurring opinion of Goodrich, J., in Pritchard v. Liggett & Myers Tobacco Co., 295 F.2d 292 (3d Cir. 1961). No liability for defect in an established product where defendant can have no knowledge of risk. Comment, 63 COLUM. L. REV. 515, 535 (1963).

in this area. In addition, the majority also seems to be in agreement on at least two essential points: first, that this is liability in *tort,* not contract, and that the law would be well served by the elimination of often misleading contractual language and concepts from the area;[25] and second, that while this new liability should be strict in the sense that plaintiff need not prove negligence to justify his recovery, it should *not* be strict in the sense that no defenses are available.[26]

It is generally conceded that the defense of assumption of the risk is applicable in actions brought under strict liability. Whether the court denominates the liability as contractual[27] or tortious,[28] it is recognized that where plaintiff voluntarily and unnecessarily proceeds in the face of a perceived risk, his recovery ought to be precluded. Of course, in cases such as *Green,* where there could have been no recognition of the danger, the defense is obviously inapplicable, but there is no logical reason why it should not apply to *future* plaintiffs—those who begin to use the product, or continue to use it in a climate of general knowledge that its use is likely to result in a given injury.[29]

The applicability of the defense of contributory negligence as a bar to recovery in these suits is less clear. Courts, trapped in the crippling concepts of contractual "warranty" are plainly reluctant to allow the use of purely tort theories,[30] and are forced to adopt

[25] See generally Prosser, *The Assault Upon the Citadel (Strict Liability to the Consumer), supra* note 13. See also RESTATEMENT (SECOND), TORTS, § 402A, question 5 at 32 (Tent. Draft No. 6 1961), explaining deletion of word "warranty" from the section.

[26] See generally 1 FRUMER & FRIEDMAN, *op. cit. supra* note 14, at § 16.01[3].

[27] *E.g.,* Chapman v. Brown, 198 F. Supp. 78 (D.C. Hawaii 1961), *aff'd,* 304 F.2d 149 (9th Cir. 1962); Walker v. Hickory Packing Co., 200 N.C. 158, 16 S.E.2d 668 (1941). In a footnote to its opinion in *Green,* the Florida court noted without comment that the question of assumption of the risk was not raised in the case. 154 So. 2d at 170 n.2(a).

[28] Greenman v. Yuba Power Products, Inc., 59 Cal. 2d 67, 27 Cal. Rep. 697, 377 P.2d 897 (1963) (by implication). See generally 1 FRUMER & FRIEDMAN, *op. cit. supra* note 14, at § 16A[3][a]; Prosser, *The Assault Upon the Citadel (Strict Liability to the Consumer), supra* note 13 at 1148 n.290 (1960).

[29] See generally PROSSER, TORTS, § 55 (2d ed. 1955).

[30] *But cf.* Greenman v. Yuba Power Products, Inc., 59 Cal. 2d 67, 27 Cal. Rep. 697, 377 P.2d 897 (1963). This was the first court to describe manufacturer's product liability as purely tortious. *Cf.* 1 FRUMER & FRIEDMAN, *op. cit. supra* note 14, at § 16A[2] (discussing implications of *Greenman*).

some other rationale such as "improper use"[31] to bar the recovery of the undeserving plaintiff.[32] There is an important line of cases, to which later reference will be made, which permit proof of contributory negligence as a defense to an award of consequential damages while refusing to allow its assertion in bar of the action.[33]

Such is the state of the law today. The courts, despite their instinctive dislike of extensive imposition of liability without fault, are being gradually pushed ever farther along the path indicated years ago in the *MacPherson* case.[34] The increasing complexities of modern life have forced some fettering of the right to freely engage in unrestricted enterprise. The imposition of absolute liability in tort upon the manufacturer for all his products is the easily recognizable trend.[35] The *Green* decision is but indicative of this trend.

In fairness, it must be conceded that both plaintiff and defendant in the cigarette cases can marshall equally valid and convincing arguments in support of their respective positions. For the plaintiff who took up smoking years ago, it might be contended that he was "encouraged" to adopt the habit.[36] Or, assuming no enticement, the

[31] *E.g.,* Nelson v. Union Wire Rope Corp., 39 Ill. App. 2d 73, 187 N.E. 2d 425 (1963); Vincent v. Nicholas E. Tsiknas Co., 337 Mass. 726, 151 N.E.2d 263 (1958). See generally 1 FRUMER & FRIEDMAN, *op. cit. supra* note 14, at §§ 16.01[3], 19.08[1].

[32] There are, however, cases which permit assertion of contributory negligence even in the warranty context. Sloan v. F. W. Woolworth Co., 193 Ill. App. 620 (1915); Parish v. Great Atlantic & Pacific Tea Co., 13 Misc. 2d 33, 177 N.Y.S.2d 7 (Mun. Ct. 1958). *Contra,* Hansen v. Firestone Tire and Rubber Co., 276 F.2d 254 (6th Cir. 1960); Bahlman v. Hudson Motor Car Co., 290 Mich. 683, 288 N.W. 309 (1939). See also Chapman v. Brown, 198 F. Supp. 78 (D.C. Hawaii 1961), *aff'd,* 304 F.2d 149 (9th Cir. 1962), where the court viewed contributory negligence as inapplicable unless it "practically amounts to an assumption of the risk." 198 F. Supp. at 86. See generally Prosser, *supra* note 13, at 1147-48; Weston, *supra* note 23.

[33] Razey v. J. B. Colt Co., 106 App. Div. 103, 94 N.Y.S. 59 (1905); Walker v. Hickory Packing Co., 220 N.C. 158, 6 S.E.2d 668 (1941). The rationale as expressed by Williston: "If the buyer's own fault or negligence contributed to the injury, as by using the goods with knowledge of their defects, he cannot recover consequential damages, since such damages were under the circumstances not proximately due to the breach of warranty." 3 WILLISTON, SALES § 614b (rev. ed. 1948).

[34] MacPherson v. Buick Motor Co., 217 N.Y. 382, 111 N.E. 1050 (1916). This case was the first to allow recovery from a remote vendor for pure negligence, and without regard to privity. Although not concerned with warranty, it is generally considered to be the landmark case in the area of products liability.

[35] "The assault upon the citadel ... is proceeding in these days apace." Prosser, *supra* note 13, at 1148.

[36] In the *Pritchard* case, the court discusses at length some of the adver-

argument remains that defendant is in a better position to absorb and pass on to the consuming public the losses occasioned by use of his product.[37] In favor of the "future" plaintiff referred to above, it could be asserted that, notwithstanding the climate of general knowledge in which he began to smoke, he could never, as a matter of law, assume the risk that his use of a *marketed product in its intended manner* would fatally injure him. Even if it were conclusively proven and announced daily that smoking causes cancer, it might still be argued that such public information should not insulate a manufacturer who is deliberately, *and for profit,* flooding the market-place with millions of potential killers.

Answering the first plaintiff above, defendant can righteously maintain that the defect was an "unknowable" one; that chemically, the defect was natural to and inseparable from the product; that he merely *processed* the product and added nothing to it which might cause injury; and that, while the standard of merchantability is admittedly higher than that of commercial acceptability when products destined for intimate human use are involved, it is still not an absolute guarantee of perfection. He may further contend that, although his position does enable him to pass his losses to the consuming public, this argument is valid only so long as there are a limited number of plaintiffs. As claims increase, his efforts to remain in business by distributing the loss would necessarily drive him into bankruptcy; and this, he can argue, is a result contrary to the policy favoring the satisfaction of a legitimate public demand in a free enterprise system. Each of these arguments can be as validly asserted against the "future" plaintiff; and to his claim, defendant could also affirmatively plead assumption of the risk.

---

tising claims made by Liggett & Myers to the effect that smoking would "make you feel better," and that in order to "Play Safe—Smoke Chesterfield." 295 F.2d at 297. The court thought that a jury might find therein an express warranty, and reversed the directed verdict for defendant on this and other grounds. *Ibid.* The second trial ended in a verdict for defendant, the jury finding in answer to special interrogatories (1) That there had been no express warranty, (2) nor a breach of the warranty implied by law. They did expressly find that plaintiff had *assumed the risk.* N.Y. Times, Nov. 10, 1962, p. 27, col. 1.

[37] See the famous concurring opinion of Traynor, C. J., in Escola v. Coca-Cola Bottling Co., 24 Cal. 2d 453, 461, 150 P.2d 436, 440 (1944). Dean Prosser indicates that there has been a growing acceptance of the rationale even by some critics who initially denounced it as socialistic. Prosser, *supra* note 13, at 1120. See generally PROSSER, *op. cit. supra* note 29, § 56.

The likelihood of legislation outlawing the sale of cigarettes and their relegation to the present status of opiates seems slight, at least in the foreseeable future. Thus, unless science is able to afford a cure for cancer, the problem will be a continuing one. The courts, sensing this, have been understandably reluctant to open the way for the flood of litigation which is certain to follow the first successful plaintiff. But relief of some kind must eventually be granted, and the time for serious consideration of the alternatives is at hand. Several possibilities suggest themselves.

First, of course, the legislature might grant statutory exemption from liability to this class of manufacturer, though it seems unlikely from a public policy standpoint. Or, courts could accept the *Green* rationale, and permit recovery in cases where defendant is unable to assert assumption of the risk. This will subject manufacturers to an immediate inundation of suits by "old" users. The privity requirements[38] and similar barriers[39] prevalent in many states would serve to hold early recoveries down to some extent; and by the time the tort concept of the action achieves more general acceptance, most plaintiffs will be members of an "assuming" class. Losses might thus be distributed to the public with only a temporary requirement of a prohibitive price increase. Again, the situation might be solved by the manufacturers themselves. If they become convinced that plaintiffs will be more and more successful as time passes, they might direct their efforts toward limiting the award of damages. They would thus admit their liability and seek, through legislation, some form of regulated award similar to that now in effect in the area of workmen's compensation. In light of the historical trend toward ever-higher damage verdicts they might, by conceding liability now, avoid terrific loses in the future.

[38] North Carolina, for example, still requires privity for maintenance of an action on implied warranty, despite a strong dictum in Davis v. Radford, 233 N.C. 283, 63 S.E.2d 822 (1951), to the contrary. Our latest pronouncement indicates that no change is impending. Wyatt v. North Carolina Equipment Co., 253 N.C. 355, 117 S.E.2d 21 (1960).

[39] Discussion of the other "barriers" in plaintiff's path is beyond the scope of this note. Throughout, it has been assumed that plaintiff was "otherwise qualified," and no attempt has been made to treat problems such as privity, proof of causation, effect of disclaimers, survival of the action, the requirement of service of adequate notice of breach to defendant, nor those related to the statute of limitations. Each could easily be the subject of a separate note or comment. The present effort has simply been an attempt to critically view the destination toward which the current law seems inevitably bound.

As the matter now stands, courts seem too concerned with *absolutes*. Both opinions in the *Green* case arrived at "total" resolutions of the question of liability—each diametrically opposed to the other. Neither recognized that, if all parties are to be justly treated, the situation is one which demands compromise. It is submitted that the best solution lies in judicial acceptance of the logic implicit in Williston's statement regarding the award of consequential damages.[40] For out-of-pocket expenses occasioned by use of a product, unmerchantable due to some common class defect, the courts should allow virtually automatic recovery. The question of damages beyond this amount, however, should be treated as a matter for separate consideration. So treated, this recovery should either be denied outright, or at the very least be deemed subject to a counter-attack by the manufacturer utilizing the classic tort defenses of contributory negligence and assumption of the risk.[41]

HENRY S. MANNING, JR.

Torts—Employer's Duty to Infant Independent Contractor

In a recent Pennsylvania case,[1] the administratrix of the estate of a deceased thirteen year old boy brought a wrongful death and survival action against the boy's employer, a newspaper publisher. The administratrix charged that the defendant was negligent in "that it permitted and caused him to travel a dangerous route in close proximity to a busy highway with a newspaper bag over his shoulders containing approximately 75 newspapers . . . ."[2] In an effort to avoid the effect of the workmen's compensation statute it was alleged that the deceased had been employed as an independent contractor. The defendant filed a motion to dismiss on the ground that the complaint failed to state a claim for relief. It contended that the characterization of deceased as an independent contractor was an admission that defedant had no control over the means by which the deceased accomplished his work and therefore it owed him no duty. However, the United States District Court for the Eastern District

[40] See note 33 *supra*.

[41] See cases cited note 24 *supra*. See also 36 So. CAL. L. REV. 490 (1963) (reaching essentially the same conclusion).

[1] Swartz v. Eberly, 212 F. Supp. 32 (E.D. Pa. 1962).

[2] *Id.* at 33.

of Pennsylvania held that the duty owed the infant independent contractor is the same as that owed an infant employee and that a claim for relief was stated.[3]

In passing on the motion to dismiss the court was faced with the problem of determining the extent of the duty owed an independent contractor by his employer rather than the more familiar problem of the duty owed an employee.[4]

It is generally accepted that control is the basis for distinguishing between employees and independent contractors.[5] If the employer has the right to control the means of performing the contract the worker is an employee.[6] On the other hand, if his right to control is limited to requiring certain definite results pursuant to the contract then the worker is an independent contractor.[7] The reduced degree of control the employer may exercise in the case of the independent

---

[3] *Id.* at 35.

[4] The employer of employees owes a duty to exercise due care to provide a reasonably safe place to work. *E.g.*, Cooley v. Walther, 226 Ark. 612, 291 S.W.2d 515 (1956); Sneed v. Lidman, 342 Mass. 228, 172 N.E.2d 836 (1961); Baumgartner v. Holslin, 236 Minn. 325, 52 N.W.2d 763 (1952); Riggs. v. Empire Mfg. Co., 190 N.C. 256, 129 S.W. 595 (1925).

He must also exercise due care to provide the employee with reasonably safe appliances. *E.g.*, Lewis v. Curran, 17 Cal. App. 2d 689, 62 P.2d 800 (1936); Cherry v. Hawkins, 243 Miss. 392, 137 So. 2d 815 (1962); Holt v. Oval Oak Mfg. Co., 177 N.C. 170, 98 S.E. 369 (1919).

The employer of an infant employee owes a further duty to warn and instruct the infant of any dangers he might encounter in his work but which because of his age and intelligence he would not appreciate. *E.g.*, Combs v. W. P. Sullivan & Co., 272 Ky. 522, 114 S.W.2d 754 (1958); Jenkins v. Jenkins, 220 Minn. 216, 19 N.W.2d 389 (1945); McLaughlin v. Black, 215 N.C. 85, 1 S.E.2d 130 (1939); Rummel v. Dilworth, Porter & Co., 131 Pa. 509, 19 Atl. 345 (1890).

[5] *E.g.*, MacMillan v. Montecito Country Club, Inc., 65 F. Supp. 240 (S.D. Cal. 1946); Turner v. Lewis, 282 S.W.2d 624 (Ky. 1955); Cooper v. Asheville Citizen Times Publishing Co., 258 N.C. 578, 129 S.E.2d 107 (1963); Tennessee Valley Appliances, Inc. v. Rowden, 24 Tenn. App. 487, 146 S.W.2d 845 (1940). See generally Steffen, *Independent Contractor and the Good Life*, 2 U. CHI. L. REV. 501 (1935); 25 MARQ. L. REV. 109 (1941).

[6] *E.g.*, MacMillan v. Montecito Country Club, Inc., 65 F. Supp. 240 (S.D. Cal. 1946); Jack & Jill, Inc. v. Tone, 126 Conn. 114, 9 A.2d 497 (1939); Pearson v. Peerless Flooring Co., 247 N.C. 434, 101 S.E.2d 301 (1958); Feller v. New Amsterdam Cas. Co., 363 Pa. 483, 70 A.2d 299 (1950). MECHEM, AGENCY § 13 (4th ed. 1952); RESTATEMENT (SECOND), AGENCY §§ 2(2), 220 (1958).

[7] *E.g.*, Cawthon v. Phillips Petroleum Co., 124 So. 2d 517 (Fla. Dist. Ct. App. 1960); Allen v. Kraft Food Co., 118 Ind. App. 467, 76 N.E.2d 845 (1948); Income Life Ins. Co. v. Mitchell, 168 Tenn. 471, 79 S.W.2d 572 (1935). MECHEM, AGENCY § 14 (4th ed. 1952); RESTATEMENT (SECOND), AGENCY § 2(3) (1958). See generally MECHEM, AGENCY §§ 427-31 (4th ed. 1952); Annot., 19 A.L.R. 226 (1922).

contractor has led courts to immunize employers from liability to a third party who is injured by the independent contractor in the course of his work.[8] It is this same difference in the extent of control that has served as a basis for the idea that the employer of an independent contractor owes him no duty while the independent contractor is performing the contract.[9] Despite the existence of this idea courts have recognized a duty to independent contractors[10] but at the same time have clung to the idea that a difference in the extent

[8] Batt v. San Diego Sun Pub. Co., 21 Cal. App. 2d 429, 69 P.2d 216 (1937); Morris v. Constitution Publishing Co., 84 Ga. App. 816, 67 S.E.2d 407 (1951); Brownrigg v. Allvine Dairy Co., 137 Kan. 209, 19 P.2d 474 (1933); Skidmore v. Haggard, 341 Mo. 837, 110 S.W.2d 726 (1937).

[9] *E.g.*, Arizona Binghamton Copper Co. v. Dickson, 22 Ariz. 163, 195 Pac. 538 (1921). "The general rule is that a contractor cannot recover damages from his employer for injuries he may sustain in the performance of his contract, and it is predicated upon the fact that the contractor has control and is bound, as every principal is to provide for his own safety and protection." *Id.* at 170, 195 Pac. at 540.

[10] Dingman v. A. F. Mattock Co., 15 Cal. 2d 622, 104 P.2d 26 (1940); Reardon v. Exchange Furniture Store, Inc., 37 Del. 321, 183 Atl. 330 (1936); Hall v. Holland, 47 So. 2d 889 (Fla. 1950); Gowing v. Henry Field Co., 225 Iowa 729, 281 N.W. 281 (1938); Edwards v. Johnson, 306 S.W.2d 845 (Ky. 1957); Resnikoff v. Friedman, 124 Minn. 343, 144 N.W. 1095 (1914); McLaughlin v. Creamery Package & Mfg. Co., 130 S.W.2d 656 (Mo. Ct. App. 1939); Magnolia Petroleum Co. v. Barnes, 198 Okla. 406, 179 P.2d 132 (1946); Stepp v. Renn, 184 Pa. Super. 634, 135 A.2d 794 (1957).

In dictum in Deaton v. Board of Trustees, 226 N.C. 433, 38 S.E.2d 561 (1946), the North Carolina Supreme Court stated the employer's liability as follows: "[I]t is generally held that one who is having work done on his premises by an independent contractor is under the obligation to exercise ordinary care to furnish reasonable protection against the consequence of hidden dangers known, or which ought to be known, to the proprietor and not to the contractor or his servants." *Id.* at 438, 38 S.E.2d at 564. This was recognized as the law of North Carolina in Brooks v. United States, 194 F.2d 185 (4th Cir. 1952).

In Henry v. White, 259 N.C. 282, 130 S.E.2d 412 (1963), the deceased, an electrician, was killed on defendant's premises while attempting to repair refrigeration machinery which he had installed earlier. Finding the deceased an independent contractor, the court stated: "The duty imposed on an employer to exercise care to provide a reasonably safe place for his employees to work... does not extend to non-employee "trouble-shooters," specialists in their field who respond to owner's call to service and repair a machine.... The owner must warn of hidden dangers known to the owner but unknown to the other." *Id.* at 284, 130 S.E.2d at 413.

This case was decided on the ground that deceased assumed the risk of a danger which he was in a better position to assess than the owner, rather than on the ground of a particular relationship between the deceased and the owner. Nevertheless, it further illustrates that North Carolina requires a less rigid standard of employers of independent contractors than of those engaging employees.

of control should result in a difference in the duties owed to the two classes.[11]

The principal case is a departure from this idea.[12] It not only holds there is a duty owed the infant independent contractor but bases it on the duty owed an infant employee in Pennsylvania. That duty is to warn and instruct the infant of any dangers he might encounter in his work but which because of his age and intelligence he would not appreciate.[13] This writer believes the decision of the court was correct. The duty to warn and instruct, to be effective, must be performed prior to commencement of the work. Thus, control of the means of performing the work is not a prerequisite to the effective performance of such duty and should not be grounds for lessening the duty owed an infant because he is employed as an independent contractor rather than an employee.

The soundness of the principal case, which subjects the employer to the same liability in certain instances whether he utilizes an independent contractor or an employee, should be recognized by those employers such as newspaper publishers, who have traditionally employed infants. The characterization of the worker as an independent contractor may continue to prevent liability from being imputed to the employer in tort situations involving third parties[14] but if the holding of the principal case is followed in other jurisdictions such employers will find their liability for injuries suffered by the infant independent contractor himself greater than if the same party had come under workmen's compensation.

MARVIN E. TAYLOR, JR.

[11] Cases cited note 10 *supra.*

[12] In Missouri the employer owes an independent contractor working on his premises the same duty he owes an invitee. Stein v. Battenfeld Oil & Grease Co., 327 Mo. 804, 39 S.W.2d 345 (1931). In an earlier case, Cummings v. Union Quarry & Constr. Co., 231 Mo. App. 1224, 87 S.W.2d 1039 (1935), it was held that the duty owed an independent contractor was substantially the same owed an employee where the employer furnished and retained control of the premises. Roach v. Herz-Oakes Candy Co., 357 Mo. 1236, 212 S.W.2d 758 (1948), reiterated the requirement that the employer furnish and retain control before the same duty could be imposed. The facts indicate the premises were furnished in all three cases. This leaves control as the real distinguishing factor.

[13] Fisher v. Delaware & Hudson Canal Co., 153 Pa. 379, 26 Atl. 18 (1893); Rummel v. Dilworth, Porter & Co., 131 Pa. 509, 19 Atl. 345 (1890).

[14] Cases cited note 8 *supra.*

Torts—Invasion of Privacy—Right to Retreat from the Spotlight

In one respect invasion of privacy is a confused theory of tort liability.[1] The confusion occurs when a right of privacy is claimed by a person who has, at some time in the past, achieved fame or notoriety through some act or because of some unfortunate circumstance, but is no longer in the public spotlight. This results from the difficulty in balancing an individual's "right to be let alone,"[2] or to reform, with that of the public's interest in an unimpeded access to newsworthy information.[3] A different and simpler aspect of the theory is raised when there is no public interest in the published material, because then there is no public policy protecting the publisher.[4] Conversely, if the material published is of public interest, there is no right of privacy.[5]

The most famous treatment of a person's right of privacy when he has receded from the spotlight is the California case of *Melvin v. Reid*.[6] Defendant published a movie, "The Red Kimono," based on

[1] The general theory on which a cause of action for invasion of privacy is based has been stated as follows: "A person who unreasonably and seriously interferes with another's interest in not having his affairs known to others or his likeness exhibited to the public . . . ." will be held liable for such interference. RESTATEMENT, TORTS, § 867 (1939).

[2] COOLEY, TORTS, 29 (2d ed. 1889).

[3] "[T]he interest of the public press in the free dissemination of the truth and unimpeded access to news is so broad, so difficult to define and so dangerous to circumscribe that courts (are) reluctant to make such factually accurate public disclosures tortious, except where the lack of any meritorious public interest in the disclosure is very clear . . . ." Jenkins v. Dell Pub. Co., 251 F.2d 447, 450 (3d Cir. 1958), *affirming* 143 F. Supp. 952 (W.D. Pa. 1956).

[4] Reed v. Real Detective Pub. Co., 63 Ariz. 294, 162 P.2d 133 (1945).

[5] That question is answered by the following language found in Cohen v. Marx, 94 Cal. App. 2d 704, —, 211 P.2d 320, 321 (1950): The Rights of "a person who by his accomplishments, fame or mode of life, or by adopting a profession or calling which gives the public a legitimate interest in his doings, affairs, or character, is said to become a public personage, and thereby relinquishes a part of his right of privacy." *Accord,* Estill v. Hearst Pub. Co., 186 F.2d 1017 (7th Cir. 1951); Smith v. National Broadcasting Co., 138 Cal. App. 2d 807, 292 P.2d 600 (1956); Schnabel v. Meredith, 378 Pa. 609, 107 A.2d 860 (1954). However, this is true only so long as such publications are reported accurately. See Leverton v. Curtis Pub. Co., 192 F.2d 974 (3d Cir. 1951); Bernstein v. National Broadcasting Co., 129 F. Supp. 817 (D.D.C. 1955), *aff'd,* 232 F.2d 369 (D.C. Cir. 1956); Garner v. Triangle Publications, Inc., 97 F. Supp. 546 (S.D.N.Y. 1951); Meetze v. Associated Press, 230 S.C. 330, 95 S.E.2d 606 (1956).

[6] 112 Cal. App. 285, 297 Pac. 91 (1931).

facts taken from the life of the plaintiff as a prostitute. Though the facts were a matter of public record, the plaintiff objected because eight years before she had changed her ways and was now married and leading a respectable life.[7] Plaintiff recovered, but liability was predicated upon a provision in the California constitution,[8] rather than recognition of a general right of privacy. However, in the course of its opinion, the court made reference to the defendant's "unnecessary and indelicate"[9] use of the plaintiff's name, and Prosser has used this language to formulate a test—"publication of matters violating the ordinary decencies"[10]—for recovery based upon invasion of the right of privacy.

In a recent case,[11] the Delaware court was asked to use the "unnecessary and indelicate" test in judging facts bearing similarity to those in *Melvin v. Reid.* Plaintiff's name was used in accurately describing the last incident of corporal punishment in Delaware.[12] These facts were a matter of public record; nine years had passed since the incident occurred; and the plaintiff was leading a normal life at the time of the publication. He argued that identifying him by name was "unnecessary" because it added nothing of informational value and that his reform made the use of his name "indelicate."

[7] A lapse of time, by itself, does not reinstate a plaintiff's right of privacy as to the publication of facts. If those facts can be found in public records and are still matters of legitimate public concern, the privilege to republish exists. Estill v. Hearst Pub. Co., 186 F.2d 1017 (7th Cir. 1951); Smith v. Doss, 251 Ala. 250, 37 So. 2d 118 (1948); Cohen v. Marx, 94 Cal. App. 2d 704, 211 P.2d 320 (1950).

[8] CALIF. CONST. art. I, § 1. "All men... [have] by nature... [the right] of pursuing and obtaining safety and happiness."

[9] Melvin v. Reid, 112 Cal. App. 285, 297 Pac. 91, 93 (1931). "The use of... [plaintiff's] true name in connection with the incidents of her former life in the plot and advertisements was unnecessary and indelicate, and a willful and wanton disregard of that charity which should actuate us in our social intercourse...." *Id.* 112 Cal. App. at —, 297 Pac. at 93.

[10] Prosser, *Privacy,* 48 CALIF. L. REV. 383 (1960). Prosser has divided the tort of invasion of privacy into four categories, the second of which is "public disclosure of embarrassing private facts about the plaintiff." *Id.* at 389.

[11] Barbieri v. News-Journal Co., 189 A.2d 773 (Del. 1963).

[12] RESTATEMENT, TORTS, § 867, comment *c* (1939) states that "a public official, an actor, an author.... or one who unwillingly comes into the public eye because of his own fault... are the objects of legitimate public interest during a period of time after their conduct or misfortune has brought them to the public attention; until they have reverted to the lawful and unexciting life led by the great bulk of the community, they are subject to the privileges which publishers have to satisfy the curiosity of the public as to their leaders, heroes, villains, and victims."

Therefore, he argued, his situation was similar in all important respects to *Melvin v. Reid* which established that liability should be imposed for the "publication of matters violating the ordinary decencies."[13]

The Delaware court flatly rejected this argument and said:

> Such a rule would in reality subject the public press to a standard of good taste—a standard too elusive to serve as a workable rule of law.... There must be something more than the mere publication of facts of record relating to a matter of public interest. In the Melvin case, in our opinion, there was the fact of exploitation of plaintiff's private life for commercial profit in a medium—the motion picture—almost inevitably entailing a certain amount of distortion to capture the attention of the public.[14]

Though this statement is a flat rejection of the "unnecessary and indelicate" interpretation of *Melvin,* it is also a recognition that liability was properly imposed in that case, for reasons which were not present in *Barbieri.* According to the court, these reasons would be: use of a "medium... entailing... distortion to capture the attention of the public"[15] and "commercial exploitation" of plaintiff's name.[15a]

Many jurisdictions recognize that the right of privacy is invaded when the defendant exploits the plaintiff's name or private life for profit;[16] however, such exploitation of a person's private life for commercial profit has been a factor only where the name[17] or picture[18] of a person is used in advertising without his permission. Therefore, Delaware's application of this concept to a situation not involving advertising is a departure from the norm.[19]

---

[13] In Mau v. Rio Grande Oil, Inc., 28 F. Supp. 845 (N.D. Calif. 1939), the court allowed the plaintiff to recover basing its decision on *Melvin v. Reid.* However, it made no mention of the "unnecessary and indelicate use of a name" for the basis of its decision.

[14] Barbieri v. News-Journal Co., 189 A.2d 773, 776 (Del. 1963).

[15] *Id.* at 776-77.

[15a] *Ibid.*

[16] *E.g.,* Flake v. Greensboro News Co., 212 N.C. 780, 195 S.E. 55 (1938).

[17] Birmingham Broadcasting Co. v. Bell, 266 Ala. 266, 96 So. 2d 263 (1957); Fairfield v. American Photocopy Equipment Co., 138 Cal. App. 2d 82, 291 P.2d 194 (1955); Kerby v. Hal Roach Studios, Inc., 53 Cal. App. 2d 207, 127 P.2d 577 (1942).

[18] Pavesich v. New England Life Ins. Co., 122 Ga. 190, 50 S.E. 68 (1905); Flake v. Greensboro News Co., 212 N.C. 780, 195 S.E. 55 (1938); Pallas v. Crowley, Milner & Co., 322 Mich. 411, 33 N.W.2d 911 (1948).

[19] However, Ettore v. Philco Television Broadcasting Corp., 220 F.2d 481 (3d Cir. 1956) classified the following group of cases as involving

When an advertisement is the method of publication, it is easy to see the applicability of the concept of "commercial appropriation" as the basis for imposing liability because the sole motive of the defendant is financial gain without regard to the public's acquisition of information. It is possible to say that the same is true when the publication is not an advertisement, because no matter what the form of publication,[20] the basic wrongful act of the defendant is the commercial appropriation of a person's name or personality without permission. Even advertisements inform the public; but the small amount of informational value or benefit contained therein is not enough to offset the invasion of an individual's right of privacy. It is certainly conceivable that the same situation might be present when another form of publication is used.[21]

However, it is necessary that there be some standard which clearly defines the applicability of this concept to other forms of publication,[22] and the difficulty of defining such a standard has

"strictly commercial exploitation of some aspect of an individual's personality": Mau v. Rio Grande Oil, Inc., 28 F. Supp. 845 (N.D. Cal. 1939); Gill v. Curtis Pub. Co., 38 Cal. 2d 273, 239 P.2d 630 (1952); Melvin v. Reid, 112 Cal. App. 285, 297 Pac. 91 (1931); Cason v. Baskin, 155 Fla. 198, 20 So. 2d 243 (1944); and Flake v. Greensboro News Co., 212 N.C. 780, 195 S.E. 55 (1938). *Id.* at 486, n.9.

[20] That entertainment is a legitimate goal and in most instances privileged and that publications giving out facts of legitimate public concern are privileged is not questioned here; however, just as the privilege to publish news can be abused by fictitious additions to a story or publication of non-newsworthy items; entertainment mediums can also use a person's name or picture for a commercial motive. Of course courts will permit limited scrutiny of the private lives of public figures. See Garner v. Triangle Publications, Inc., 97 F. Supp. 546 (S.D.N.Y. 1951). But when this is carried to the point of appropriation should the courts not find this as objectionable as using a name in advertising?

[21] In Cason v. Baskin, 155 Fla. 198, 20 So. 2d 243 (1944), the defendant wrote a book about the section of Florida in which the plaintiff lived containing a vivid description of the plaintiff's masculine characteristics and her constant use of profanity. The court allowed recovery for this use of the elements of her personality without her consent even though it recognized that the book had legitimate entertainment and informational value.

[22] Informational value could, of course, vary with the type of book, radio program, television program, or motion picture, and one could find extremes in each of these mediums that would range from absolute documentary presentations to utter fantasy. Therefore, each case should be strictly determined on its facts and not by the category in which it might fall. This segregation of mediums is meant to be only a rough indication of the amount of informational value one might expect generally from a particular medium. In order to provide a working standard, Gill v. Curtis Pub. Co., 38 Cal. 2d 273, 239 P.2d 630 (1952) set out the following factors for consideration: (1) the medium of publication; (2) the extent of the use; (3) the public

caused some courts to refuse to recognize an individual's right in this situation at all.[23] Still other courts, when faced with flagrant intrusions on an individual's rights, have imposed liability for such reasons as "unnecessary and indelicate" use of a person's name[24] or the presence of distortion without more.[24a] The Delaware court refused to follow either of these alternatives. Instead it would examine the published material to see if there was a legitimate public interest in the specific statements complained of. If it did not find such an interest, it would then impose liability if it found that the publisher's intent was other than serving the public's right of access to newsworthy information.[25] In other words, if the court had found that use of the plaintiff's name was currently newsworthy, it would have gone no further. But, finding this interest lacking, it examined the publisher's intent and found that the intention was to satisfy the public's interest in the merits of corporal punishment, even though the use of the name did not accomplish the purpose.

Such a test protects a publisher from liability when he makes a mistake, and it keeps the emphasis where it belongs—on the public's right—but it has, to some degree, the same flaw as the "unnecessary and indelicate" test because it is hard to apply. In this respect the court thought the medium of publication important, and in many situations this would be a good test. In *Melvin,* for instance, the medium was a motion picture, and motion pictures are generally published to entertain, not to inform. On the other hand because certain forms of publication may involve mixtures of informational and entertainment value, this test, like the "unnecessary and indelicate" test will be difficult to apply. However, this is not necessarily so in every instance as the intent or motive of a publisher producing distorted fictional dramatizations can readily be distinguished from that present when a publication performs the service of satisfying the

interest served by the publication; and (4) the seriousness of the interference with the person's privacy. See also, RESTATEMENT, TORTS, § 867, comment *d* (1939), which states, "In determining liability, the knowledge and motives of the defendant, the sex, station in life, previous habits of the plaintiff with reference to publicity, and other similar matters are considered."

[23] Generally courts will not distinguish between news for information and news for entertainment. Chaplin v. National Broadcasting Co., 15 F.R.D. 134, 138-39 (S.D.N.Y. 1953).

[24] Melvin v. Reid, 112 Cal. App. 285, 297 Pac. 91 (1931).

[24a] Leverton v. Curtis Pub. Co., 192 F.2d 974 (3d Cir. 1951).

[25] Barbieri v. News-Journal Co., 189 A.2d at 776-77.

more important interest of the public in unimpeded access to newsworthy information. In the latter there should not be recovery; but it is objectionable that in the former this public interest is said to protect a publisher when such an interest is not present at all, simply because it might have been. It is submitted that upon finding a lack of legitimate public interest in the specific statements complained of, a court should base its decision on a further investigation of whether the defendant's intent was to commercially exploit plaintiff's private life.

RICHARD BURROWS

Trusts—Deviation from Investment Restrictions

In 1924 James B. Duke established the Duke Endowment when he transferred to trustees a large amount of securities, the income of which was to be used for educational, religious and other charitable purposes.[1] The trust indenture provided that the trustees could invest the funds of the trust in either government bonds or Duke Power Company securities, other investments being prohibited. In 1962 over 80% of the trust was invested in common stock of Duke Power, and over 95% of the remaining common stock was invested in two aluminum companies.[2] The trustees brought an action for modification of the trust instrument to permit them to invest in stocks and bonds of corporations other than Duke Power. Basing their opinion on New Jersey law because of the terms of the trust instrument,[3] the North Carolina Supreme Court said that a court

[1] 20% of net income is to be set aside until an additional $40,000,000 has been added to the trust. The remaining income is payable 32% to Duke University, 32% to such nonprofit hospitals in North and South Carolina as the trustees select, 5% to Davidson College, 5% to Furman University, 4% to Johnson C. Smith University, 10% to nonprofit organizations in North and South Carolina selected by the trustees which are engaged in caring for orphans, 2% for care of needy retired Methodist preachers, or widows and orphans of deceased Methodist preachers in North Carolina, 6% to be used in erecting rural Methodist churches in North Carolina, and 4% for maintenance and supervision of such churches. Cocke v. Duke Univ., 260 N.C. 1, 5-6, 131 S.E.2d 909, 911 (1963).

[2] Stocks in companies other than Duke Power were received from either Mr. Duke or his estate. In 1962 the number of shares and the values of aluminum company stocks held by the trust were as follows: 791,040 shares of Aluminum Ltd., of Canada, valued at $17,402,880; 639,644 shares of Alcoa common, valued at $35,180,420; 59,300 shares of Alcoa preferred, worth $5,040,500. *Id.* at 13, 131 S.E.2d at 916.

[3] The trust by its express language is "executed by a resident of the State

of equity may authorize a trustee to disregard the provisions of the trust instrument limiting his authority with respect to the kind of securities in which he may invest, but that the evidence in this case did not justify exercise of that power.[4]

The trustees could invest funds of the trust in either Duke Power securities or government bonds, neither of which appeared desirable to them. On the one hand they felt it would not be advisable, from a diversification standpoint, to purchase additional securities of Duke Power, because of the size of the trust's holding of that corporation's securities.[5] On the other hand, they felt it unwise to invest in fixed-dollar obligations since additional funds would be needed in the future to offset inflation and increasing population.[6] Thus, the trustees argued, neither government bonds nor Duke Power securities offered attractive investment potential for the trust fund; therefore they should be allowed to invest in securities of companies other than Duke Power to protect the beneficiaries and the objects of the trust.

The plaintiffs' evidence showed that since the creation of the trust the country has entered a period of general inflation which has not yet ended, and that the cost of higher education and hospital costs have increased and probably will continue to increase faster than average.[7] Officials of the beneficiary colleges projected large increases in enrollment as well as in educational costs per student in the future.[8] Trust investment experts testified that they were of the opinion that "proper safeguarding of the corpus of the Endowment requires a greater degree of diversification"[9] and "that the

of New Jersey in said State, is intended to be made, administered and given effect under and in accordance with the present existing laws of said State, notwithstanding it may be administered and the beneficiaries hereof may be located in whole or in part in other states, and the validity and construction thereof shall be determined and governed in all respects by such laws and statutes." *Id.* at 8, 131 S.E.2d at 913. See note 14, *infra,* for a discussion of other possible implications of this language.

[4] Cocke v. Duke. Univ., 260 N.C. 1, 131 S.E.2d 909 (1963).

[5] Also, a witness of the trustees had testified that Duke Power is now a mature company which cannot expect future expansion at a rate comparable to that of the past. *Id.* at 19, 131 S.E.2d at 921.

[6] There was evidence showing that the needs of the beneficiaries will continue to increase because of expanding population. *Id.* at 13, 131 S.E.2d at 917.

[7] Record, p. 151.

[8] Record, pp. 189-208.

[9] 260 N.C. at 14, 131 S.E.2d at 917.

restrictive investment provisions set forth in the Indenture constitute a threat to the safety of the Endowment corpus."[10]

The court referred to a New Jersey statute[11] and two cases in the New Jersey Court of Errors and Appeals[12] as "declaring the law which must be applied here."[13] Briefly stated, the law upon which the court relied holds that in order to change investment procedures in New Jersey, the trustee must show that because of changes in conditions not anticipated by the settlor, such a change would be necessary to avoid frustration of the purposes of the trust, and that the new investment policy would be advantageous to the purposes of the trust and to all beneficiaries. It would seem that the North Carolina court properly applied the present law of New Jersey in reaching its decision.[14] Although there was substantial evidence

[10] *Ibid.*

[11] N.J. STAT. ANN. tit. 3A, ch. 15, § 15(b) (1953), which reads in part: "If the court shall find that by reason of a change in conditions which occurs since the creation of the trust or which may be reasonably foreseen, the objects of the trust might be defeated in whole or in part by the investment... of all the funds of such trust in the kinds of investments to which the trustee is then limited by the statutes of this state or by the instrument... creating such trust and that the objects of the trust and the interests of all the beneficiaries thereof... would be promoted by the investment of all, or some part, of the trust fund otherwise, the court shall... authorize or direct the trustee ...to invest... in any class of investments, including common or preferred stocks of corporations...."

[12] Bliss v. Bliss, 126 N.J. Eq. 308, 8 A.2d 705 (1939); Reiner v. Fidelity Union Trust Co., 126 N.J. Eq. 78, 8 A.2d 175 (1939); *rev'd* 127 N.J. Eq. 377, 13 A.2d 291 (1940). In the *Bliss* case a large portion of the principal of a trust under a will was invested in railroad bonds; under the terms of the will the trustees could reinvest funds of the trust in legal securities. Both income and corpus diminished considerably, and the trustee sought permission to reinvest in common and preferred stocks, which were not legal trust investments. The court said that under the provisions of the will the trustee had broad investment power and denied authority to make the proposed investments because there was no evidence that the purposes of the trust were likely to be defeated if the required change were denied. In the *Reiner* case a trust's income was to be paid to the settlor's daughter; distribution of the principal to her was to be made over a period of years. Income from legal securities had shrunk from over $70,000 in 1925 to $54,000 in 1937, but there had been no substantial diminution of the principal. The court was asked to empower the trustee to invest portions of the trust fund in common stock. The court refused because there was no evidence that the purposes of the trust would have been defeated if the requested investments were not allowed.

[13] 260 N.C. at 8, 131 S.E.2d at 913.

[14] A question arises, however, as to whether or not *current* New Jersey law should have been applied in the case. The general rule governing the administration of an inter vivos trust is stated in RESTATEMENT, CONFLICT OF LAWS § 297 (1934), as follows: "A trust of movables created by

showing why it would have been advantageous to grant the requested relief, there was not sufficient evidence of the *necessity* of

an instrument inter vivos is administered by the trustee according to the law of the state where the instrument creating the trust locates the administration of the trust." Comment *d* thereunder says, "In order to determine where the administration of the trust is located, consideration is given to the provisions of the instrument, the residence of the trustees, the residence of the beneficiaries, the location of the property, the place where the business of the trust is to be carried on." A majority of the trustees reside in North Carolina; most of the beneficiaries are located in North and South Carolina; the physical location of the securities held by the trust is in New York. Record, p. 206. The Endowment maintains two of its three offices in North Carolina. Thus, taking into consideration the elements set out above by the Restatement, it would seem that the trust would be administered according to the law of North Carolina, or possibly South Carolina or New York, nothing appearing in the trust instrument to the contrary. But the draftsman foresaw that a controversy might arise with respect to the administration of the trust and for that reason provided in the indenture that the trust was to be administered "in accordance with the *present existing* laws and statutes of [New Jersey]" (emphasis added). 260 N.C. at 8, 131 S.E.2d at 913. If this language be interpreted to mean that future administrative acts be according to the law of New Jersey as of the date of each act, then it would appear that the court properly based the decision on the statute and two subsequent cases, since the statute would apply to trusts created before its passage. See Reiner v. Fidelity Union Trust Co., 126 N.J. Eq. 78, 8 A.2d 175 (Ch. 1939). But if the language be interpreted as requiring that the trust be administered according to the laws of New Jersey at the time of the creation of the trust, then the statute and above cases would not seem to be authority on which to base the decision, because the trust was created in 1924, thirteen years before the statute passed and long before the cases were decided by the Court of Errors and Appeals. Under this interpretation it would seem that the settlor, in effect, included in the indenture his own rules governing administration of the trust, to be used wherever the trust was being administered. To put it another way, he incorporated by reference into the trust indenture the 1924 laws of New Jersey, which became part of the indenture itself. Thus it would appear that a subsequent New Jersey statute would have no effect upon it. This point was raised by the defendants, Brief for Defendants, pp. 39-43, but the court did not explain why it held that the statute and cases declared "the law which must be applied here."

Apparently courts of chancery in New Jersey had jurisdiction in 1924 to permit investments of trust funds in securities other than those allowed by the trust instrument. See Price v. Long, 87 N.J. Eq. 578, 101 A. 195 (1917). Two later cases have said that courts of equity have always had the inherent authority to do so. Morris Community Chest v. Wilentz, 124 N.J. Eq. 580, 3 A.2d 808 (1939); New Jersey Nat'l Bank & Trust Co. v. Lincoln Mortgage and Title Guar. Co., 105 N.J. Eq. 557, 148 A. 713 (1930). But the court could exercise the power only in an emergency, where the circumstances required that something be done. Price v. Long, *supra*. Thus the 1937 statute and subsequent cases, though perhaps incorrectly applied in the principal case, have not significantly changed the law in this area, and under the law prevailing in New Jersey at the time the trust was created a similar result probably would have been reached.

doing so. It was on this ground that the court granted the motion for nonsuit.

The instant case would seem to fall within the scope of the generally accepted doctrine that equity has no authority to alter a trust merely to improve a settlor's gift to the beneficiaries.[15] Under this view the power to permit deviation by the trustee should be limited to emergency situations that threaten the purposes of the trust. The general principle being acknowledged, the critical question is what circumstances actually do create an emergency warranting deviation. An interesting comparison to the principal case is afforded by two fairly recent cases, *Stanton v. Wells Fargo Bank & Union Trust Co.*[16] and *In re Trusteeship under Agreement with Mayo.*[17]

In the *Stanton* case the trust instrument executed in 1930 provided that investments by trustees should be made only in bonds of the federal government, states or municipalities, or in corporate bonds rated at least "AA" by Moody's Investment Service.[18] Total dollar values of the trust in the following years were as follows: 1931—3,460,516 dollars; 1936—2,323,719 dollars; 1954—2,860,687 dollars.[19] Income in 1938 was 88,891 dollars and in 1954 was 109,943 dollars.[20] The plaintiff felt that the evidence showed a marked decline in the purchasing power of the dollar and the return on bonds (as compared to the return on common stocks). However, the court observed that there was no evidence of any beneficiary's being in want, or of the distributable income being insufficient to supply the reasonable needs of all the beneficiaries. The court admitted that inflation had occurred in the past, but said that no one knows whether or not it will continue in the future. The court felt it should not try to guess what economic conditions might be in the future by permitting the deviation where no real need or emergency was shown, and refused to allow deviation.

[15] See, *e.g.*, Rogers v. English, 130 Conn. 332, 33 A.2d 540 (1943); Porter v. Porter, 138 Me. 1, 20 A.2d 465 (1941); Thomson v. Union Nat'l Bank, 291 S.W.2d 178 (Mo. 1956); John A. Creighton Home v. Waltman, 140 Neb. 3, 299 N.W. 261 (1941); Toledo Trust Co. v. Toledo Hosp., 174 Ohio St. 124, 187 N.E.2d 36 (1962); RESTATEMENT (SECOND) TRUSTS § 167, comment *c* (1959); 3 BOGERT, TRUSTS AND TRUSTEES § 561 (1946).

[16] 150 Cal. App. 2d 763, 310 P.2d 1010 (1957).

[17] 259 Minn. 91, 105 N.W.2d 900 (1960).

[18] Stanton v. Wells Fargo Bank & Union Trust Co., 150 Cal. App. 2d 763, 766, 310 P.2d 1010, 1012 (1957).

[19] *Id.* at 767, 310 P.2d at 1013.

[20] *Id.* at 771, 310 P.2d at 1016.

In the *Mayo* case there were two trusts set up—one in 1917 and the other in 1919. The donor died in 1939. The investment provisions of both said the following: "The TRUSTEES shall... manage, care for and protect said fund all in accordance with their best judgment and discretion, invest and re-invest the same in real estate mortgages, municipal bonds or any other form of income bearing property (but not real estate or corporate stock) ...."[21] The value of the assets of the larger trust was $957,712 in 1940 and $968,893 in 1958; but due to inflation the value of the trust in terms of 1940 dollar values was only $456,140 at the later date.[22] That is, the actual value of the trust fund, in terms of purchasing power, had been cut almost in half since 1940, due to inflation. A similar decline in purchasing power had taken place in regard to the smaller trust. The court said that unless deviation was ordered the dominant intention of the donor to prevent a loss of the principal would be frustrated; and that unless deviation be allowed, the assets of the trusts within the next twenty years would be worth less than one-fourth of their value at the time of the donor's death. Another factor considered was that stocks are now sounder investments than they were at the time the trust was created, due to increased government and exchange regulations and improved management. The court felt that the trustees should have the right to deviate from the restrictive provisions of the trust and permitted them to invest a reasonable amount of the trusts in corporate stocks. In this way the trusts were to be fortified against inflation.

When the court in the *Mayo* case found that the dominant intention of the donor was to prevent a loss in the principal, it provided itself with a necessary fact upon which to base its decision.[23] Also it would seem that the court was sensible in recognizing that inflation decreases the value of the principal even though its value in dollars does not decrease, and in recognizing the probability of

[21] 259 Minn. at 92-3, 105 N.W.2d at 902.

[22] *Id.* at 93, 105 N.W.2d at 902.

[23] In Toledo Trust Co. v. Toledo Hosp., 174 Ohio St. 124, 187 N.E.2d 36 (1962), the plaintiff relied upon the *Mayo* case in seeking to deviate from the investment provisions of the trust instrument because inflation had devalued the purchasing power of the dollar. In denying relief the court said, "The court in the Mayo case reached these two conclusions by first concluding that the dominant intention of the testator was to preserve the corpus of the trust. It is difficult for this court to reach that conclusion under this trust...." *Id.* at 127, 187 N.E.2d at 39.

future inflation. Because of the facts found in *Stanton,* there was no basis upon which to hold that the purpose of the trust was threatened, and so the court could not grant relief. It is regrettable that the court in *Stanton* took the narrow view prohibiting recognition of future inflation, because this approach seems to ignore a strong economic trend of recent years which is generally expected to continue.[24] Although the trust in the principal case was charitable rather than private,[25] the facts of that case would seem to be more in line with the *Stanton* case than with *Mayo,* since there were not sufficient findings of substantial danger to the accomplishment of the trust purpose. Although the investment provisions do not seem to be the best possible, this alone is not a sufficient ground to change them under general trust principles and the laws of New Jersey. In spite of this, a slightly different emphasis by the court would have allowed a more advantageous holding without violating established trust principles. The court could have found justifiably that the trust's purposes were substantially endangered by the investment restrictions. From the settlor's instructions to add part of the income to the principal, the court could have plausibly concluded that the settlor's main intention was either to prevent loss of the principal or to increase the size of the trust fund. Under either conclusion his intention could have been defeated because of the great imbalance of investments which subjects the trust to undue risk. If the court felt the latter to be his intention, it could have reasonably determined that the investment restrictions would retard the growth of the trust fund, thereby defeating the settlor's intention partially or wholly. Likewise, the court could have determined that the investment restrictions would prevent growth of the trust fund at a rate sufficient to meet the beneficiaries' needs in the future, when additional funds would be necessary because of increased population and inflation, thereby thwarting the settlor's obvious intention to fulfill their needs. Thus, as was done in *Mayo,* the court could have furnished

[24] "Among the few things which economists predict with any degree of confidence is that—with some possible exceptional periods—prices will, on the average, be higher in future decades than they are today." *Why Prices Stay Up,* Nation's Business, Feb., 1963, p. 64. But see Upgren, *The American Economy: 1933 to 1973,* 17 J. AM. SOC'Y C.L.U. 329 (1963).

[25] Since the typical charitable trust is intended to last a very long time, it is reasonable and necessary to allow the trustee more flexibility than in the case of private trusts. See 4 POWELL ON REAL PROPERTY 488 § 579 (1954).

itself with a basis upon which to hold that the trust purposes were endangered, thereby fulfilling the requirement necessary to allow deviation under existing law.

COWLES LIIPFERT

Wills—Incorporation by Reference—Invalid Instruments

In *Godwin v. Wachovia Bank & Trust Co.*[1] husband and wife executed a trust agreement which the court conceded to be void as an inter vivos trust because of the draftsman's failure to obtain and certify a private examination of the wife as required by section 52-12 of the General Statutes. Both husband and wife executed wills of even date with the trust instrument, each disposing of his property as provided in the trust agreement. After the wife's death the husband executed a new will which differed substantially from the terms of the trust agreement. In an action by the trustee seeking specific performance of an alleged contract between husband and wife to will their property according to the terms of the trust agreement, the court held that the trust agreement was incorporated in the respective wills by reference; that the wills themselves established the existence of the alleged contract; and that the trustee was entitled to specific performance for the benefit of the beneficiaries named in the original wills.

The doctrine of incorporation by reference[2] is recognized in England and in a great majority of American jurisdictions.[3] Four fea-

[1] 259 N.C. 520, 131 S.E.2d 456 (1963).

[2] This doctrine should not be confused with the closely related doctrine of "facts of independent legal significance." Professor Scott states, in reference to the latter doctrine, that: "[A] disposition made in a will is not invalid although its terms do not fully appear in the will, if those terms can be ascertained from facts which have significance apart from their effect upon the disposition in the will. The existence of a trust at the time of the testator's death, created by him at some time prior to his death, is such a fact. *It is not the trust instrument, but the trust itself, which has independent significance.*" 1 SCOTT, TRUSTS § 54.3, at 367 (2d ed. 1956). (Emphasis added.)

Since a valid inter vivos trust was never created here, and the trust instrument cannot be a fact of independent significance, this doctrine would seem inapplicable.

[3] ATKINSON, WILLS § 80, at 385 nn. 4-5 (2d ed. 1953), and cases cited therein. The doctrine is stated thusly in Newton v. Seaman's Friend Soc'y, 130 Mass. 91, 93 (1881): "If a will, executed and witnessed as required by statute, incorporates in itself by reference any document or paper not so executed and witnessed, whether the paper referred to be in the form of a will or codicil, or of a deed of indenture, or of a mere list or memoran-

tures are generally requisite to an application of the doctrine: (1) the extraneous document must have been in existence at the time of the execution of the will;[4] (2) it must be referred to in the will as being in existence at the time of execution;[5] (3) it must be identified by satisfactory proof as the paper referred to;[6] and (4) the intention of the testator to incorporate the paper or document in his will must clearly appear from the will.[7]

The doctrine is based upon a fiction that the unattested instrument, invalid as a testamentary disposition by itself, becomes in-

---

dum, the paper so referred to, if it was in existence at the time of the execution of the will, and is identified by clear and satisfactory proof as the paper referred to therein, takes effect as part of the will, and should be admitted to probate as such."

[4] "An attempt to incorporate a future document is ineffectual, because a testator cannot be permitted to create for himself the power to dispose of his property without complying with the formalities required in making a will." Simon v. Grayson, 15 Cal. 2d 531, 533, 102 P.2d 1081, 1082 (1940).

[5] Magoohan's Appeal, 117 Pa. 238, 14 Atl. 816 (1887).

[6] See Bottrell v. Spengler, 343 Ill. 476, 175 N.E. 781 (1931). Varying degrees of strictness have characterized the decisions as to sufficiency of identification. A direction to pay legacies "according to the directions written in a book by [M. W. P.], . . . signed by me . . . and witnessed by said [M. W. P.] . . . ," was held a sufficient description in Newton v. Seaman's Friend Soc'y, 130 Mass. 91 (1881). The statement "this is a codicil to my last will and testament" was definite enough to refer to an improperly executed will where no other will was found. Allen v. Maddock, 11 Moo. P.C. 427, 14 Eng. Rep. 757 (1858). A reference to an amount owed "on my books" was sufficient where testator kept only one set of accounts. *In re* Bresler's Estate, 155 Mich. 567, 119 N.W. 1104 (1909). Where two papers were found in decedent's pocketbook, neither of which alone would constitute a valid testamentary disposition, but which would when construed together, and one referred to another paper "in my pocketbook," it was held to incorporate the other so as to constitute a valid will. *In re* Miller's Estate, 128 Cal. App. 176, 17 P.2d 181 (Dist. Ct. App. 1932).

On the other hand, reference to "a sealed letter which will be found with this will" was held not to be a "clear, explicit, unambiguous reference to any specific document as one existing and known to the testator at the time his will was executed." Bryan's Appeal, 77 Conn. 240, 58 Atl. 748 (1904). Mention of furniture "which she has got a list of" was not sufficient. *In re* Goods of Greves, 1 Sw. & Tr. 250, 164 Eng. Rep. 715 (1858). A testamentary provision reciting that testator had executed deeds to named grantees, and that "said deeds" should become effective on testator's death as provided in the deeds, did not describe the deeds sufficiently to incorporate them in the will by reference. Brooker v. Brooker, 130 Tex. 27, 106 S.W.2d 247 (1937). And, where a will provided that "the balance be given to Kirwan on a special purpose," parol evidence was not admissible to show that the "special purpose" was fully described in a letter of even date with the will when the will made no allusion to such letter. Lawless v. Lawless, 187 Va. 511, 47 S.E.2d 431 (1948).

[7] Bottrell v. Spengler, 343 Ill. 476, 175 N.E. 781 (1931); Witham v. Witham, 156 Or. 59, 66 P.2d 281 (1937); Richardson v. Byrd, 166 S.C. 251, 164 S.E. 643 (1932).

corporated into the will at the place where the reference to it occurs; consequently, the instrument is supported by the statutory formalities regulating the execution of wills.[8] The policy considerations that underlie allowing such incorporation are basically uncomplicated. Primarily it is based upon the simple rule of convenience. The necessity of setting out in the will a lengthy trust instrument is eliminated. The testator may simply refer to the trust in one sentence, properly identifying and describing it, and declare that said trust is then in existence and that it is his intent to incorporate the same into his will. The courts will then refer to the terms of the trust in the administration of testator's will and estate.[9] Perhaps equally significant is the social desirability of permitting the testator's intention to be realized whenever possible.[10] When incorporation by reference is attempted, the courts are called upon to balance the intention of the testator against the technical requisites of the Statute of Wills;[11] when intention prevails, it may often be at a sacrifice of the basic statutory policy.[12]

Sacrifice of statutory policy seems to be the primary rationale for disallowing incorporation by reference. While three other states[13]

[8] 17 U. PITT. L. REV. 519, 520 (1956). See also Malone, *Incorporation, by Reference, of an Extrinsic Document Into a Holographic Will,* 16 VA. L. REV. 571, 572-73 (1930): "The basis of the prevailing view is, apparently, that when the will itself is properly signed and witnessed, the statutory safeguards against fraud and imposition have been given full effect."

[9] 2 PAGE, WILLS § 19.17 (Bowe-Parker rev. 1960).

[10] Evans, *Nontestamentary Acts and Incorporation by Reference,* 16 U. CHI. L. REV. 635, 636 (1949). "If the intent of the testator is certain and the possibility of fraud is eliminated, the incorporation of all formal trust instruments should be allowed." 33 ST. JOHN'S L. REV. 169, 171 (1958).

[11] The original English Statute of Wills was enacted in 1540. 32 Hen. 8, c. 1 (1540). In a session held in 1542 and 1543 parliament passed 34 & 35 Hen. 8, c. 5, clarifying loosely drawn parts of the earlier act. The present North Carolina statutory law governing wills is found in N.C. GEN. STAT. ch. 31 (1950).

[12] 6 ARK L. REV. 496, 498 (1952). It has been argued, however, that the majority rule effectuates the testator's intention, while keeping the spirit of the statute inviolate by means of the narrow limits within which the operation of the rule is confined. 11 COLUM. L. REV. 456 (1911).

[13] Louisiana, New Jersey, and New York. The following dictum is often stated as representing the Louisiana position: "And it may be conceded at once that a will cannot be made by mere reference to another document not itself a will or to a former will that is invalid for want of proper form. All the French authorities agree on that." Succession of Ledet, 170 La. 449, 453, 128 So. 273, 274 (1930). Dicta opposing incorporation are cited from numerous New Jersey cases in 2 PAGE, WILLS § 19.21 (Bowe-Parker rev. 1960). But Swetland v. Swetland, 102 N.J. Eq. 294, 140 Atl. 279 (Ct. Err. & App. 1928), *affirming* 100 N.J. Eq. 196, 134 Atl. 822 (Ch. 1926), seems to

are often cited as denying incorporation by reference, only Connecticut has a square holding rejecting it.[14] The argument there was, in effect, that the doctrine "militates against the authentication of the entire will, makes possible the sort of fraud against which the Statute of Frauds and the Wills Act were aimed, and is inconsistent with the requirement that a will be signed 'at the end thereof.' "[15] A further consideration was that the doctrine of incorporation by reference was developed in England prior to enactment of the Statute of Wills. The court reasoned that the statement or public policy in the statute overruled the previously established judicial doctrine.[16]

Incorporation by reference is not expressly prohibited by the Wills Act. From the requirements that a will must be signed, published, and attested in a certain way, some courts have deduced that the testator's purpose must be gathered from the will and not from other documents which lack the prescribed marks of authenticity. Denial of incorporation by reference is a product of judicial construction, designed to prevent fraud and mistake, and to uphold the statutory policy.[17]

North Carolina has consistently held with the majority view allowing incorporation by reference.[18] The leading case, *Watson v. Hinson*,[18a] states the North Carolina position thusly:

> It is well recognized in this State that a will, properly executed, may so refer to another unattested will or other written paper or document as to incorporate the defective instrument and make the same a part of the perfect will, the conditions being that the paper

recognize the doctrine. The leading New York case rejecting the doctrine is Booth v. Baptist Church, 126 N.Y. 215, 28 N.E. 238 (1891). *But see In re* Fowles' Will, 222 N.Y. 222, 118 N.E. 611 (1918) and *In re* Rausch's Will, 258 N.Y. 327, 179 N.E. 755 (1932), where the court said the rule against incorporation by reference should not be carried to a "dryly logical extreme."

[14] Hatheway v. Smith, 79 Conn. 506, 65 Atl. 1058 (1907).

[15] Evans, *Incorporation by Reference, Integration and Non-Testamentary Act*, 25 COLUM. L. REV. 879, 880 (1925).

[16] Hatheway v. Smith, 79 Conn. 506, 65 Atl. 1058 (1907).

[17] *In Re* Fowles' Will 222 N.Y. 222, 118 N.E. 611 (1918).

[18] Bullock v. Bullock, 17 N.C. 307 (1832) (books of account held incorporated, used to construe subsequent provision of will); Siler v. Dorsett, 108 N.C. 300, 12 S.E. 300 (1891) (case lost by parties seeking incorporation for failure to put extrinsic document in evidence, but doctrine clearly recognized); *In re* Coffield, 216 N.C. 285, 4 S.E.2d 870 (1939) (codicil incorporated and revised revoked will); Watson v. Hinson 162 N.C. 72, 77 S.E. 1089 (1913) (propounders granted new trial where second instrument made clear reference to one former will, and this feature had been allowed no effect as to validity of first).

[18a] 162 N.C. 72, 77 S.E. 1089 (1913).

> referred to shall be in existence at the time the second will is executed, and the reference to it shall be in terms so clear and distinct that from a perusal of the second will or with the aid of parol or other proper testimony, full assurance is given that the identity of the extrinsic paper has been correctly ascertained.[19]

In two cases[20] North Carolina has refused to allow incorporation by reference; however, this refusal was based upon the failure to meet the requirement of sufficiency of identification of the document to be incorporated rather than upon any limitation of the doctrine itself.

The significant and somewhat unique aspect of the instant case is the allowance of incorporation of an instrument that in itself was invalid. The authority on the point is sparse,[21] and neither the courts nor the commentators have articulated with any thoroughness the philosophical bases for such a result. It would seem, on the one hand, that an instrument invalid as an inter vivos document should not undergo a change in character by mere incorporation into a will. To hold otherwise would seem to undermine the policy behind the initial invalidity. The invalidity in the principal case resulted from failure to obtain the private examination of the wife as required by section 52-12 of the General Statutes. The purpose of the statute is to prevent frauds by the husband upon the wife,[22] and our court has stated that the statute proceeds on the idea, "not that there *is fraud,* but that there *may be fraud.*"[23] Strict application of the

[19] *Id.* at 79-80, 77 S.E. at 1092 (1913).

[20] Bailey v. Bailey, 52 N. C. 44 (1859); Chambers v. McDaniel, 28 N.C. 226 (1845).

[21] Our court cites the following in support of its holding: 94 C.J.S *Wills* § 163 (1956); Montgomery v. Blankenship, 217 Ark. 357, 230 S.W.2d 51 (1950); Fifth Third Union Trust Co. v. Wilensky, 79 Ohio App. 73, 70 N.E.2d 920 (1946); *In re* Sciutti's Estate, 371 Pa. 536, 92 A.2d 188 (1952). Of these only *Montgomery* seems truly applicable. The writer found little else directly in point, despite an abundance of authority on incorporation by reference itself.

Apparently the only case refusing to allow incorporation of an invalid instrument is Clark v. Citizens Nat'l Bank, 38 N.J. Super. 69, 118 A.2d 108 (Ch. 1955). The court there held the existence of a valid trust on the date of the execution of the will to be essential to incorporation, and thus refused to allow incorporation of an invalid trust instrument. The case is criticized in 17 U. PITT. L. REV. 519 (1956).

[22] Stout v. Perry, 152 N.C. 312, 67 S.E. 757 (1910); Long v. Rankin, 108 N.C. 333, 12 S.E. 987 (1891); Sims v. Ray, 96 N.C. 87, 2 S.E. 443 (1887).

[23] Lee v. Pearce, 68 N.C. 76, 81 (1873).

statutory policy would have rendered the trust agreement void through no actual fraud is apparent. By allowing incorporation by reference, the court has given preference to the intention of the testatrix. Whether the court would have reached a similar result had the husband rather than the trust beneficiaries been asserting that the trust agreement embodied the wife's intention—a situation more directly involving the statutory policy—is a matter for speculation.[24]

The few courts which have allowed incorporation of an invalid instrument have done so on the grounds that the instrument embodies the intention of the testator, the theory being that it is the extrinsic writing itself, and not the legal effect, which should be looked to.[25] In *Skerett's Estate*[26] California allowed a deed which was invalid for lack of delivery to be incorporated into a testamentary writing. The intention of the testator was allowed to prevail over the formalities of conveyancing. "Any other conclusion," said the Pennsylvania court in a similar case, "would result in an unreasonable violation of testator's scheme of distribution."[27] Where testator devised his estate to a trust agreement which he had previously revoked, the Ohio court held that it was his "obvious intent" to employ the disposition in the trust agreement as the terms of his will, on the ground that a testator is never presumed to intend to die intestate as to any part of his estate to which his attention seems to have been directed.[28] In the *Godwin* case the allowance of incorporation would seem to implement the intention of the testators as embodied in the trust agreement and the original wills.

In balancing the policy behind a document's invalidity against a testator's intention, North Carolina has squarely held that the testator's intention may be given effect by allowing incorporation into

[24] The result reached would seem also to run counter to our "pour-over trust" statute, N.C. GEN. STAT. § 31-47 (Supp. 1961), which seems to contemplate a previously established, valid, existing trust as prerequisite to a valid devise or bequest.

[25] 17 U. PITT. L. REV. 519 (1956). Despite Professor Scott's contention that it is the trust itself and not the trust instrument that has independent significance, this argument sounds a great deal like the doctrine of "facts of independent significance." See note 2, *supra*.

[26] 67 Cal. 585, 8 Pac. 181 (1885).

[27] *In re* Hogue's Will, 135 Pa. Super. 543, 550, 6 A.2d 108, 111 (1939). See also Thompson's Ex'rs v. Lloyd, 49 Pa. 127 (1865).

[28] Fifth Third Union Trust Co. v. Wilensky, 79 Ohio App. 73, 70 N.E.2d 920 (1946).

a will of an invalid instrument. The *Godwin* case places North Carolina among a small group of states with decisions on the precise question, and helps to mark the state as a liberal jurisdiction on the doctrine of incorporation by reference.

WILLIS PADGETT WHICHARD