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# Notes and Comments

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# NOTES AND COMMENTS

## Minimum Capital Requirements of Broker-Dealers

The basic function of a broker-dealer[1] is the execution of orders for the purchase and sale of securities either for himself or his customers. The activities[2] of broker-dealers result in the accumulation of a large aggregate of customers' property. Today more than 46 billion dollars in securities and one billion dollars in cash are entrusted to broker-dealers by customers.[3] Large customer cash accounts result from dividends paid on shares held in street name, proceeds of sales, and deposits in anticipation of future purchases. Brokers hold shares as security until payment is made by customers for their purchases. Shares listed in street name or customer name are often left with a broker for trading convenience. Shares are also held by the broker-dealer to secure the loans of margin customers, to whom the broker-dealer has advanced a portion of the purchase price.[4] In addition, the broker-dealer's business activities go beyond that of trading; he may engage in underwritings, carry inventories of stock in which he makes a market, or trade extensively for his own account, all accomplished largely by borrowing from banks and other broker-dealers or by using funds of his customers. With a large extent of borrowing by the broker-dealer,

[1] Sections 3(A)(4) and 3(A)(5) of the Securities Exchange Act of 1934 define the terms "broker" and "dealer" as follows: a broker is "any person engaged in the business of effecting transactions in securities for the account of others . . . ." 48 Stat. 882, 15 U.S.C. § 78c(a)(4) (1958); a dealer is "any person engaged in the business of buying and selling securities for his own account . . . ." 48 Stat. 882, 15 U.S.C. § 78c(a)(5) (1958). The term "broker-dealer" is used here to indicate a situation where an individual (including sole proprietorships, partnerships, and corporations) combines the activities of both broker and dealer, or where there is uncertainty as to whether a person is acting in one capacity or the other. Furthermore, "broker-dealer" refers to one that affects purchases or sales of securities that take place on the over-the-counter markets.

[2] There are approximately 6,000 broker-dealers engaged in the over-the-counter business in the United States. About 5,000 are registered with the SEC, meaning that they use the mails and instrumentalities of interstate commerce to effect transactions. The remainder do business that is exclusively intrastate or exclusively in exempt securities such as federal government, state and municipal issues. The bulk of the over-the-counter business is handled by the approximately 5,500 broker-dealers who are members of the NASD. LEFFLER, THE STOCK MARKET 402-09 (3d ed. 1963).

[3] Note, 77 HARV. L. REV. 1290 (1964).

[4] *Id.* at 1292.

coupled with the accumulation of customer's property, any insolvency on the part of the broker-dealer and resulting inability to meet loan calls and other financial obligations presents a serious danger to the investing public. Thus, the financial responsibility of broker-dealers is necessary to afford protection to the individual customer and the investing public in general.

The financial responsibility of broker-dealers is subject to regulation by one or all of three sources: (1) the federal government, (2) the self-regulatory bodies, *i.e.*, the stock exchanges and the National Association of Securities Dealers (NASD), and (3) state governments. We shall examine the tripartite imposition of net capital requirements that take three forms: (1) net capital-to-indebtedness ratios, (2) minimum net capital requirements, and (3) bonding requirements.

## I. Federal Regulation

Federal regulation[5] of the financial responsibility of broker-dealers is accomplished mainly by rule 15c3-1,[6] promulgated under the Securities Exchange Act of 1934. However, section 8(b)[7] of the Exchange Act, which establishes a net capital-to-indebtedness ratio requirement for brokers-dealers who are members of national securities exchanges or those broker-dealers who transact business through members of such exchanges, also regulates broker-dealers in this area. Therefore, it is necessary to investigate this provision briefly before examining rule 15c3-1.

### *A. Section 8(b)*

Section 8(b) makes it unlawful for any broker-dealer who is a member of a national exchange or who transacts a business in securities through the medium of an exchange member, directly or indirectly,

> to permit in the ordinary course of business as a broker, his aggregate indebtedness to all other persons including customers' credit balances (but excluding indebtedness secured by exempted securities) to exceed such percentage of the net capital (exclusive of fixed assets and the value of exchange membership) employed in business, but not exceeding in any case 2,000 per centum, as

[5] A broker-dealer first entering the over-the-counter market is required to register with the SEC as a condition to dealing across state lines. 78 Stat. 570 (1964), 15 U.S.C. § 78o(a)(1) (Supp. 1964).

[6] SEC Rule 15c3-1, 17 C.F.R. § 240.15c3-1 (1964).

[7] 48 Stat. 888 (1934), 15 U.S.C. § 78h(b) (1958).

> the Commission may by rates and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors.[8]

The section's obvious purpose is to safeguard customers against the risk of a broker-dealer's insolvency by prohibiting him from borrowing more than twenty times his net capital. But section 8(b) is inapplicable to dealers who do no brokerage business, even though they may hold customer's funds or securities, or to brokers who do not transact business through the medium of an exchange member. Even as to those broker-dealers covered by section 8(b), it applies only to indebtedness incurred in the normal course of business as a broker-dealer and not to any obligations outside of that business.[9]

The SEC applied the 20:1 ratio of section 8(b) in a few early cases[10] of broker-dealer insolvency. However, the section has never been implemented by rule, and for approximately four decades, the Commission has generally chosen to proceed against broker-dealers under rule 15c3-1 rather than under section 8(b).[11]

### *B. Rule 15c3-1*

The rule was first announced in 1942 in the case of *National Association of Securities Dealers, Inc. v. SEC*,[12] where the Commission stated that it had promulgated its own net capital-to-indebtedness ratio rule applicable to the entire over-the-counter industry because it recognized a need for general rules to achieve customer protection against financially unsafe broker-dealers. The rule was adopted under section 15(c)(3) of the Exchange Act, which prohibits any broker-dealer from using the mails or interstate facilities to effect any transaction in or to induce the purchase of any security otherwise than on a 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 to provide safeguards with respect to the financial responsibility of brokers and dealers.[13]

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[8] *Ibid.*

[9] 2 Loss, SECURITIES REGULATION 1350 (2d ed. 1961).

[10] *E.g.*, Baird v. Franklin, 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944); SEC v. Lawson, 24 F. Supp. 360, 362 (D. Md. 1938).

[11] SEC, *Report of Special Study of Securities Markets*, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 1, at 407 n.377 (1963) [hereinafter cited as Special Study].

[12] National Ass'n of Sec. Dealers, Inc. v. SEC, 12 S.E.C. 322 (1942).

[13] 52 Stat. 1075 (1938), 15 U.S.C. § 78o(c)(3) (1958).

The rule itself, as adopted under section 15(c)(3), is simple in statement: "No broker or dealer shall permit his aggregate indebtedness to all other persons to exceed 2,000 per centum of his net capital."[14]

It should be emphasized from the outset that rule 15c3-1 is both an entry requirement for the broker-dealer and a continuous, operational requirement that the broker-dealer must meet throughout the course of business. However, it is not so much a qualification device as it is a continuous, operational requirement.[15]

The rule is vigorously enforced by the SEC and is one of the most important weapons in the Commission's arsenal for assuring the solvency of broker-dealers. By limiting the ratio of broker-dealer's indebtedness to his capital, and thereby restricting the amount which he may borrow, the rule operates to some extent to assure confidence and safety to the investing public.[16]

### C. *Definition of Rule 15c3-1 and Explanation of Its Operation*

Although the rule itself is simple in statement, it is complex in its definition of the terms "net capital" and "aggregate indebtedness." The complexity has been justified, however, because the rule, and its technical wording, is intended for particular application to those with expertise in the specific business of executing orders for the purchase and sale of securities.[17]

The rule is imposed on all broker-dealers who are subject to the broad jurisdictional language of the registration section[18] of the Exchange Act, with two exceptions. First, those brokers who act solely as agents for issuers in soliciting subscriptions to issuers' securities, promptly transmitting the securities and proceeds, and who hold or owe no customers' securities or funds are not covered

[14] SEC Rule 15c3-1(a), 17 C.F.R. § 240.15c3-1(a) (1964).

[15] Special Study, pt. 1, at 86.

[16] Blaise D'Antoni & Associates, Inc. v. SEC, 289 F.2d 276, 277 (5th Cir. 1961).

[17] SEC v. Fairfax Investment Corp., CCH FED. SEC. L. REP. ¶ 91432 (1964). Any objections to the accounting techniques required by the rule on grounds that the procedures are not in accord with standard accounting practices have been rejected thus: "Unless it can be shown that rule 15c3-1 is clearly an abuse of the Commission's rulemaking power, it is not incumbent on the courts to look behind the rule and determine how it might have been drafted more in accordance with concepts of good accounting. So long as the accounting procedure is in conformity with the rule, it must be deemed proper." SEC v. Graye, 156 F. Supp. 544, 546 (S.D.N.Y. 1957).

[18] 78 Stat. 570 (1964), 15 U.S.C. § 78o(a)(1) (Supp. 1964).

by the rule.[19] Clearly, there is little possibility of large borrowing by the broker-dealer in such a transaction and hence no immediate fear of insolvency. Also, since the broker-dealer holds no customer funds or securities, there is no danger to the customer. Second, members of seven specified stock exchanges whose rules and settled practices impose more comprehensive requirements than rule 15c3-1 are also exempted from coverage.[20]

The rule defines "aggregate indebtedness" as the total money liabilities of a broker-dealer arising in connection with any transaction he engages in, including such items as money borrowed, money payable against securities loaned and securities "failed to receive" that have not been sold by the broker-dealer, market value of securities borrowed, and credit balances in any customers' accounts that have "short positions" in securities.[21] It has been held that a reasonable provision for accrued taxes must also be included under "aggregate indebtedness."[22] However, certain items are excluded from "aggregate indebtedness." They are:

(1) Indebtedness that is "adequately collateralized" by securities owned by the broker-dealer.[23] An "adequately collateralized" indebtedness is one that would be considered a fully secured loan by banks in the community making comparable loans to broker-dealers.[24] For example, if banks generally were lending fifty per cent of the value on collateral consisting of common stock, a 10,000 dollar indebtedness secured by at least 20,000 dollars of common stocks would be "adequately collateralized." The term has the same meaning throughout the rule.

(2) Indebtedness to other broker-dealers that is "adequately collateralized" by securities owned by the broker-dealer.[25]

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[19] SEC Rule 15c3-1(b)(1), 17 C.F.R. § 240.15c3-1(b)(1) (1964).

[20] SEC Rule 15c3-1(b)(1), 17 C.F.R. § 240.15c3-1(b)(1) (1964), exempting the American, Boston, Midwest, New York, Pacific Coast, Philadelphia-Baltimore-Washington, and Pittsburgh stock exchanges.

[21] SEC Rule 15c3-1(c)(1), 17 C.F.R. § 240.15c3-1(c)(1) (1964). For a discussion of the borrowing and loaning of money and securities on the part of a broker-dealer, "fails to receive," and "positioning" in securities, see LEFFLER, *op. cit. supra* note 2, at 409-10, 432-33.

[22] Cornelis de Vroedt, Securities Exchange Act Release No. 5628 (1958).

[23] SEC Rule 15c3-1(c)(1)(A), 17 C.F.R. § 240.15c3-1(c)(1)(A) (1964).

[24] SEC Rule 15c3-1(c)(6), 17 C.F.R. § 240.15c3-1(c)(6) (1964).

[25] SEC Rule 15c3-1(c)(1)(B), 17 C.F.R. § 240.15c3-1(c)(1)(B) (1964).

(3) Amounts that are payable against securities that have been loaned if the securities are owned by the broker-dealer.[26] This exclusion operates to qualify the definition of "aggregate indebtedness," for, as seen above, the term includes money payable against any securities loaned. The result is that only money payable against securities loaned, but not owned by the broker-dealer, are included in the computation of "aggregate indebtedness."

(4) Amounts that are payable against securities "failed to receive" that were purchased for the account of the broker-dealer and have not been sold by him.[27] This exclusion also operates to qualify "aggregate indebtedness," leaving included in "aggregate indebtedness" money payable against securities "failed to receive" that have not been sold by the broker-dealer but were not purchased for the account of the broker-dealer.

(5) Indebtedness that is "adequately collateralized" by exempted securities, *i.e.*, federal government or state and municipal issues.[28]

(6) Fixed liabilities that are secured by real estate or any other assets that are not included in the computation of "net capital" under rule 15c3-1[29]—in other words, as we shall see under the definition of "net capital," any other asset that can not be readily converted into cash.

(7) Liabilities on open "contractual commitments."[30] The term "contractual commitments" generally means firm commitment underwritings that have been contracted for, but for which settlement has not been made.[31] Thus, the firm obligation of a broker-dealer, acting in the capacity of an underwriter, to purchase securities to be offered to the public would be an open "contractual commitment" and excluded from "aggregate indebtedness." But the exclusion is limited to firm commitment underwritings and is inapplicable to a best efforts underwriting, presumably on the theory that with a firm commitment underwriting the exact number of securities

[26] SEC Rule 15c3-1(c)(1)(C), 17 C.F.R. § 240.15c3-1(c)(1)(C) (1964).
[27] SEC Rule 15c3-1(c)(1)(D), 17 C.F.R. § 240.15c3-1(c)(1)(D) (1964).
[28] SEC Rule 15c3-1(c)(1)(E), 17 C.F.R. § 240.15c3-1(c)(1)(E) (1964).
[29] SEC Rule 15c3-1(c)(1)(G), 17 C.F.R. § 240.15c3-1(c)(1)(G) (1964).
[30] SEC Rule 15c3-1(c)(1)(H), 17 C.F.R. § 240.15c3-1(c)(1)(H) (1964).
[31] NASD Training Guide 100 (1963).

to be purchased is known, whereas with a best efforts underwriting the exact number is not known.[32] The reason why liabilities on open "contractual commitments" are omitted from the computation of "aggregate indebtedness" is that the securities purchased in the underwriting are considered to be in inventory and hence are subject to the net capital "haircut," explained below.[33]

(8) Indebtedness of the broker-dealer to one who has loaned him cash or securities that is subordinated to the claims of general creditors in accordance with a "satisfactory subordination agreement."[34] Since the indebtedness is made "junior" to the claims of general creditors, it is not thought necessary to include it in "aggregate indebtedness." Since the indebtedness that is subordinated to such an agreement is also excluded from the computation of "net capital," the effect is to treat the proceeds of such liabilities, more properly denominated loans, as capital.[35] However, the term "satisfactory subordination agreement" is strictly defined under the rule as a written agreement between the broker-dealer and the lender, binding on the lender and his creditors, that (a) subordinates any right of the lender to demand payment of cash or securities loaned to the claims of general creditors of the broker-dealer, (b) is not subject to cancellation at the will of either party for a term greater than one year, and (c) provides that it will not be rescinded if the effect of such recission would be to lower the net capital-to-indebtedness ratio below the prescribed limit of 20:1.[36]

An attempted summary of the above indicates that "aggregate indebtedness" essentially means the money liabilities of a broker-dealer that are not adequately collateralized by his own assets, are not subordinated by a satisfactory subordination agreement, and are not liabilities on an open contractual commitment.

"Net capital" is defined as the net worth (excess of assets over

[32] SEC v. Keith Richard Securities Corp., 148 F. Supp. 358, 360 (S.D.N.Y. 1957). See also SEC v. Los Angeles Trust Co., 186 F. Supp. 830, 859 (S.D. Cal. 1960), where the court stated that "open contractual commitment" does not include such items of indebtedness as customers' credit balances, even though the broker-dealer impliedly asserted that it had a contract with a customer with respect to the balances.

[33] The term "contractual commitments" also includes when issued, when distributed, and delayed delivery contracts. SEC Rule 15c3-1(c)(5), 17 C.F.R. § 240.15c3-1(c)(5) (1964).

[34] SEC Rule 15c3-1(c)(1)(I), 17 C.F.R. § 240.15c3-1(c)(1)(I) (1964).

[35] NASD Training Guide 100 (1963).

[36] SEC Rule 15c3-1(c)(7), 17 C.F.R. § 240.15c3-1(c)(7) (1964).

liabilities) of a broker-dealer, with certain adjustments that are designed generally to reflect the current liquid position of the broker-dealer.[37] These adjustments are:

(1) The addition of unrealized profits and the deduction of unrealized losses in securities held in the broker-dealer's accounts as inventory or in trading accounts.[38] Broker-dealers will often carry inventories in securities as part of the function of making markets in the securities. Any unrealized profits or losses in the inventories would result in an adjustment of "net capital." But the profits or losses must necessarily relate to a broker-dealer's inventory in issued securities and not to trading profits or losses in "when issued" securities, for, if the shares are not in fact issued, the unrealized profits or losses will be permanently unrealized.[39]

(2) The deduction of all assets that cannot be readily converted into cash.[40] This would include such non-liquid assets as real estate, furniture and fixtures, insurance, and good will. Where there is an indebtedness secured by such an asset, the deduction made is the excess of the value of the asset over the amount of the indebtedness.[41] In some cases the Commission has softened this provision by allowing non-marketable assets a value to the extent that a broker-dealer can demonstrate that he has received a firm bid for such assets or that they would be taken as collateral for a bank loan.[42] There is no fixed policy here; it is simply a discretionary withholding by the SEC, in certain circumstances, of compliance with the letter of the law.

(3) The deduction of specified percentages (colloquially called a "haircut") of the market value of all securities, except exempted securities, in long or short positions of the inventory or trading accounts of a broker-dealer.[43] The "haircut" percentages to be deducted vary from zero per cent for the exempted securities to thirty

[37] SEC Rule 15c3-1(c)(2), 17 C.F.R. § 240.15c3-1(c)(2) (1964).
[38] SEC Rule 15c3-1(c)(2)(A), 17 C.F.R. § 240.15c3-1(c)(2)(A) (1964).
[39] SEC v. Peerless-New York, Inc., 157 F. Supp. 328, 329 (S.D.N.Y. 1958).
[40] SEC Rule 15c3-1(c)(2)(B), 17 C.F.R. § 240.15c3-1(c)(2)(B) (1964).
[41] NASD Training Guide 104 (1963).
[42] Loss, *op. cit. supra* note 9, at 1354 n.257.
[43] SEC Rule 15c3-1(c)(2)(C), 17 C.F.R. § 240.15c3-1(c)(2)(C) (1964).

per cent. In the case of undefaulted, non-convertible debt securities with a fixed interest rate and maturity date, the deduction is five per cent, unless the securities are selling at a discount of more than five per cent, in which event the deduction is the amount of the discount up to a maximum of thirty per cent.[44] With cumulative, non-convertible first preferred stock not in arrears as to dividends, the deduction is twenty per cent.[45] On all other securities, the deduction is thirty per cent.[46] The effects of these deductions, in addition to providing a margin of safety, is to provide a salutary brake on the accumulation of securities by a broker-dealer and to prevent him from over-extending himself. Thus, if a broker-dealer invested 100,000 dollars from his capital in the purchase of stock for his own account, it would be necessary to provide an additional 30,000 dollars of capital in order to remain in the same net capital position as he had before the purchase. Similarly, if he contracted to purchase 100,000 dollars worth of securities, he would have to enter the full purchase price as a liability, but would value the stock to be acquired at only 70,000 dollars, so that 30,000 dollars in cash would be required to carry the commitment.[47] Arguments have been interposed by broker-dealers to the effect that whether or not they are within compliance with rule 15c3-1 is not in their control, as a market fluctuation may so vary the value of their securities that they could be thrown out of compliance through no fault of their own.[48] While this is the case, such an argument has been rejected by at least one court as merely going to the wisdom of the rule.[49]

(4) The exclusion of liabilities subordinated under a "satisfactory subordination agreement," the term having the same definition as it did under "aggregate indebtedness."[50] The result of excluding such liabilities in computing both "aggregate indebted-

[44] SEC Rule 15c3-1(c)(2)(C)(i), 17 C.F.R. § 240.15c3-1(c)(2)(C)(i) (1964).

[45] SEC Rule 15c3-1(c)(2)(C)(ii), 17 C.F.R. § 240.15c3-1(c)(2)(C)(ii) (1964).

[46] SEC Rule 15c3-1(c)(2)(C)(iii), 17 C.F.R. § 240.15c3-1(c)(2)(C)(iii) (1964).

[47] *Hearings Before the Subcommittee on SEC Legislation of Senate Committee on Banking & Currency on S. 1178-82,* 86th Cong., 1st Sess. 354 (1959).

[48] For an example of how such a situation might occur, see Special Study, pt. 1, at 409 n.386.

[49] SEC v. Graye, 156 F. Supp. 544, 546 (S.D.N.Y. 1957).

[50] SEC Rule 15c3-1(c)(2)(F), 17 C.F.R. § 240.15c3-1(c)(2)(F) (1964).

ness," as seen above, and "net capital" is to handle the proceeds of such liabilities, cash and securities, as capital.

(5) For broker-dealers who are sole proprietors, the deduction of the excess of liabilities not incurred in the securities business over assets not used in the business.[51]

In summary, "net capital" means the liquid net assets of a broker-dealer reduced by certain percentages of the market value of most securities and excluding indebtedness subordinated by a satisfactory subordination agreement.

### *D. Is Rule 15c3-1 Sufficient?*

By the terms of the rule, aggregate indebtedness cannot be more than twenty times greater than net capital. Thus, so long as a broker-dealer maintains a minimal amount of indebtedness, he may enter the market and continue to operate on a limited net capital. For example, each 10,000 dollar increment of indebtedness requires an increase of only 500 dollars in net capital to satisfy the rule. Thus, it appears that the rule is of limited effectiveness in fulfilling the purpose of assuring the financial responsibility and stability of broker-dealers. While it may be of importance in helping to insure the solvency of broker-dealers, it does not guarantee any minimum capital commitment and does little to screen broker-dealers at the crucial point of entry. The SEC has expressed its opinion of the rule thus: "The ease with which almost anyone can start his own securities firm has permitted many an amateur to embark on the deep water of broker-dealer entrepreneurship."[52]

The SEC has recommended in its *Report of Special Study of Securities Markets*[53] that broker-dealers be subjected to a "minimum net capital requirement" as a requisite of entry into the over-the-counter market and as an operational requirement thereafter.[54] Such a requirement would be adopted, as was rule 15c3-1, under section 15(c) of the Exchange Act. The *Special Study* listed several reasons why a minimum capital rule should be adopted. First, securities laws depend heavily on the sanction of civil liability

[51] SEC Rule 15c3-1(c)(2)(G), 17 C.F.R. § 240.15c3-1(c)(2)(G) (1964).

[52] Wall Street Journal, July 31, 1964, p. 6, col. 3.

[53] SEC, *Report of Special Study of Securities Markets*, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963) [hereinbefore and hereinafter cited as Special Study].

[54] *Id.*, pt. 1, at 161.

in favor of those who may be injured by violation of the laws by a broker-dealer; if a broker-dealer has little or no capital, he may be judgment proof, and hence the securities laws will not have the effect intended. Second, no broker-dealer should be permitted to carry on business on so thin a margin of capital that he must depend on day-to-day transactions to continue business; nor should he be permitted to rely on customers' funds and securities as a source of working capital. Third, the "smooth and speedy handling of securities transactions within the financial community itself require that all members of that community have at least such minimum of personnel and resources that they may reasonably rely on one another's ability to do business responsibly."[55] Finally, a minimum capital rule would insure that broker-dealers entering the securities business have such a sense of commitment to their business as is likely to produce responsible, reliable operations.[56] The minimum net capital rule recommended was 5,000 dollars, plus 2,500 dollars for each branch office and 500 dollars for each salesman employed at any time.[57] The nature of the recommendation suggests that the *Special Study* recognizes that the requirement should not be uniform for all broker-dealers, but should reflect the type and size of business engaged in.

Although the SEC has yet to follow the suggestion of the *Special Study,* it is very likely to adopt a minimum net capital rule in the near future. In the spring of 1964, the Commission informally circulated a proposed minimum net capital rule. It followed the *Special Study* recommendation by proposing a minimum figure of 5,000 dollars, plus 500 dollars for each salesman, but did not use the number of branch offices as a standard of scaling up the minimum. For broker-dealers dealing exclusively in mutual fund shares, the requirement would have been 2,500 dollars minimum net capital plus 250 dollars for each salesman. No action was taken, and the rule has not been formally proposed, evidently because of substantial industry opposition. Later in 1964, the SEC again informally circulated a proposed minimum net capital rule. This proposal would have required broker-dealers to maintain liquid reserves equal to at least twenty-five per cent of the cash left with them by customers. However, it too received criticism, and no formal action

[55] *Id.* at 84.
[56] *Id.* at 84.
[57] *Id.* at 162.

was taken. The Commission has announced that a new proposal is being drafted.[58]

The industry's principal objections to a minimum net capital rule are that it alone cannot assure financial or other responsibility of a broker-dealer and that a broker-dealer can engage in overly risky business practices, either in the selection of debtors or by way of speculative ventures, even though he is required to maintain a prescribed level of capital. Also, the objection is made that worthy individuals without capital may be excluded from the business.[59] Nevertheless, it appears likely that a minimum capital rule will be adopted by the SEC.

### *E. Relief for Violation of Rule 15c3-1*

Basically, the forms of relief available to the Commission for violation of its net capital-to-indebtedness ratio rule are injunctive relief, revocation or suspension of the registration of the broker-dealer with the SEC, and, if the broker-dealer is a member of a registered national securities association, suspension or expulsion from that association. Violations of the rule are detected by the Commission under section 17(a), where authority is given to make such inspection of the books and records of a broker-dealer "as the Commission may deem necessary or appropriate in the public interest or for the protection of investors."[60]

*1. Injunction.*—The issuance of an injunction under the Exchange Act is governed by section 21(e), which conditions the right to injunction upon sufficient proof that "any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation" of the act or of any rule or regulation prescribed under its authority.[61] An injunction does not seek to put the broker-dealer out of business or to harm him. It seeks only to restrain him from doing business while he is in violation of the Commission's rules.[62] The Commission is not entitled to an injunction against a broker-dealer for violation of rule 15c3-1 unless it can make a clear showing of a violation of the rule—a showing that the broker-dealer

[58] Wall Street Journal, July 31, 1964, p. 6, col. 3. See also N.Y. Times, Nov. 23, 1964, p. 59, col. 5.

[59] National Ass'n of Sec. Dealers, Inc. v. SEC, 12 S.E.C. 322, 325 (1942).

[60] 48 Stat. 897 (1934), 15 U.S.C. § 78q(a) (1958). See also SEC Rule 17a-3, 17 C.F.R. § 240.17a-3 (1964).

[61] 48 Stat. 899 (1934), 15 U.S.C. § 78u(e) (1958).

[62] SEC v. Graye, 156 F. Supp. 544, 547 (S.D.N.Y. 1957).

subjected his customers to risk by conducting its business with an excess of indebtedness.[63] Furthermore, where the violation is the broker-dealer's first and the deficit is made good immediately after the commencement of the SEC's action, an injunction will not likely issue, because it is improbable that the violation will be resumed.[64] But where there have been repeated violations of the rule in the past, an injunction will lie.[65]

*2. Revocation or Suspension of Registration with the SEC.*—Section 15(b)(5)(D) of the Exchange Act provides that the Commission, after notice and hearing, may revoke the registration of a broker-dealer for a period not exceeding twelve months or suspend him if it finds it is in the public interest and that such broker-dealer has willfully violated any of the provisions of the act or any rule or regulation thereunder.[66] This provision also authorizes the Commission to censure a broker-dealer for violation of the act. Censure can be an effective sanction against a broker-dealer, for it puts the investing public on notice that he has willfully violated the securities laws. The Commission has held that where a broker-dealer permits his aggregate indebtedness to exceed more than twenty times his net capital, this, in and of itself, is a willful violation of rule 15c3-1.[67] Substantially the same principles apply here as with injunctions. If the violation is remedied as soon as it is called to the broker-dealer's attention, there will be no suspension, revocation, or censure. But where the broker-dealer continuously violates the rule and it is likely that he will continue to do so, suspension, revocation, or censure will follow.[68]

*3. Expulsion or Suspension from NASD.*—Section 15A(1)(2)(b) authorizes the Commission, after opportunity for notice and hearing, to suspend for a maximum period of twelve months or to expel from a national registered securities association any member

[63] SEC v. Robert A. Martin Associates, Inc., CCH FED. SEC. L. REP. ¶ 91178 (1962).

[64] SEC v. Casper Rogers & Co., 194 F. Supp. 589 (S.D.N.Y. 1961); SEC v. Reither, 146 F. Supp. 552 (S.D.N.Y. 1956); SEC v. Norman Lemmons, Inc., CCH FED. SEC. L. REP. ¶ 91040 (1961); Douglass & Co., 35 S.E.C. 586 (1954).

[65] SEC v. Cohn, 216 F. Supp. 636 (D.N.J. 1963). *Accord,* SEC v. Whitaker, CCH FED. SEC. L. REP. ¶ 90998 (1960).

[66] 78 Stat. 571 (1964), 15 U.S.C. § 78o(b)(5)(D) (Supp. 1964).

[67] Hammill & Co., 28 S.E.C. 634 (1948).

[68] Whitney & Co., 40 S.E.C. 1100 (1962); Batkin & Co., 38 S.E.C. 436 (1958).

thereof who has violated any provision of the Exchange Act or any rule or regulation thereunder.[69] As the NASD is the only national securities association registered with the SEC, violation of rule 15c3-1 would result in the suspension or expulsion from that association, assuming the broker-dealer was a member.[70]

*6. Other Forms of Relief.*—Section 32(a)[71] of the Exchange Act, which provides for fines up to 10,000 dollars or imprisonment up to two years for violations of the act, is inapplicable to the net capital-to-indebtedness ratio requirement, because section 32(c)[72] specifically exempts any violation of any rule prescribed pursuant to section 15(c)(3).

The general fraud provisions[73] of federal securities regulation would seem to give rise to civil liability on the part of a broker-dealer if any refusal or failure to comply with rule 15c3-1 could be interpreted as a manipulative, deceptive, or fraudulent action. However, there appear to be no cases or rulings where a civil liability was imposed on a broker-dealer for a violation of the rule under the general fraud sections. Section 18(a)[74] of the Exchange Act would appear to be another possible source of civil liability on the part of the broker-dealer for violation of the net capital-to-indebtedness ratio rule. It provides that any person who makes any statement in a report or document that is required to be filed with the SEC under the act and was false or misleading with respect to a material fact will be liable to any person who, in reliance on the statement, purchased or sold a security at a price that was affected by such statement. Thus, if a broker-dealer filed a false or misleading statement in the financial ledgers required by rule 17a-3[75] in an attempt to portray compliance with rule 15c3-1, when in fact his aggregate indebtedness exceeded net capital by more than 2,000 per cent, and a person purchased or sold a security in reliance upon such compliance, it would seem that such person could bring a civil action against the broker-dealer under section 18(a). How-

[69] 52 Stat. 1070 (1938), 15 U.S.C. § 780-3(1)(2)(b) (1958).
[70] Heft, Kahn & Infante Inc., CCH FED. SEC. L. REP. ¶ 76897 (1963).
[71] 48 Stat. 904 (1934), 15 U.S.C. § 78ff(a) (1958).
[72] 48 Stat. 904 (1934), 15 U.S.C. § 78ff(c) (1958).
[73] Securities Exchange Act of 1934 § 15(c)(1), 48 Stat. 895, 15 U.S.C. § 78o(c)(1) (1958); § 10(b), 48 Stat. 891, 15 U.S.C. § 78j(b) (1958); Securities Act of 1933 § 17(A), 48 Stat. 84, 15 U.S.C. § 77q(A) (1958); SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1964).
[74] 48 Stat. 897 (1934), 15 U.S.C. § 78r(a) (1958).
[75] SEC Rule 17a-3, 17 C.F.R. § 240.17a-3 (1964).

ever, there are no cases or rulings indicating that a civil action could be brought under section 18(a) in such a situation. At any rate, it would be difficult to show that a person bought or sold securities in reliance on a statement in a financial ledger which indicated compliance with rule 15c3-1.

## II. Regulation by the Self-Regulatory Bodies—The Stock Exchanges and NASD

### *A. The Stock Exchanges*

The purpose of this section is to inquire into the net capital requirements that are imposed on broker-dealers who are members of the New York Stock Exchange (NYSE) and the major regional stock exchanges. Our concern will be primarily with the NYSE. Any reference to broker-dealers here will be to those who have memberships on one or more of the organized exchanges. Such broker-dealers usually have specialized departments that engage in trading on the over-the-counter market. The members of seven specified stock exchanges—the American, Boston, Midwest, New York, Pacific Coast, Philadelphia-Baltimore-Washington, and Pittsburgh —are exempted from rule 15c3-1 because their "rules and settled practices are deemed by the Commission to impose requirements more comprehensive than the requirements of this rule."[76]

Generally, the net capital-to-indebtedness ratio rules of the exchanges are the same in principle as rule 15c3-1. The primary differences are three: (1) Many exchanges have a fixed minimum net capital rule as well as a net capital-to-indebtedness ratio rule. Members of such exchanges must meet either one or the other of the rules, depending on whichever requires a greater net capital. (2) The rules of some of the exchanges require a ratio of indebtedness to net capital lower than the 20:1 ratio prescribed by rule 15c3-1. (3) The rules of certain exchanges require greater "haircuts" on certain types of securities and also give the exchanges authority to demand larger "haircuts" on securities than prescribed by the rules, if it is considered necessary and advisable.

*1. The NYSE.*—The NYSE imposes net capital requirements on broker-dealer members by virtue of its rule 325, which prescribes a net capital-to-indebtedness rule and demands a fixed minimum net capital maintenance requirement. The net capital-to-indebtedness

[76] SEC Rule 15c3-1(b)(2), 17 C.F.R. § 240.15c3-1(b)(2) (1964).

ratio required is identical to the SEC's rule 15c3-1: "No member . . . doing any business with . . . members . . . or with the public . . ., shall permit, in the ordinary course of business as a broker, his or its Aggregate Indebtedness to exceed 2,000 per centum of his or its Net Capital."[77] As to the minimum net capital requirement, rule 325 demands that member broker-dealers carrying accounts for customers maintain a fixed net capital of at least 50,000 dollars; those members doing business with other members or member organizations, or doing general business with the public but not carrying customers' accounts, must maintain a net capital of at least 25,000 dollars.[78] The rule further provides that initial net capital must be at least 120 per cent of that required to be maintained at all times. Therefore, a broker-dealer carrying customer accounts and thereby subject to the 50,000 dollar minimum capital requirement, would need 60,000 dollars of minimum net capital on initially becoming a member of the NYSE, the required amount dropping to a level 50,000 dollars after admittance. Both the ratio rule and the minimum net capital rule apply with particular force to broker-dealers having transactions with the public. However, rule 325 does not cover floor brokers, traders, and specialists having no public business. The result of prescribing both requirements is that the broker-dealer must meet either one or the other of the rules, depending on whichever requires a greater net capital. For example, assume that a broker-dealer carries no customer accounts and that therefore the 25,000 dollars minimum net capital requirement applies to him. If his aggregate indebtedness exceeded 500,000 dollars, which would be more than twenty times greater than 25,000 dollars, he would then fall under the net capital-to-indebtedness ratio rule (requiring a 20:1 ratio between capital and debt) and would be required to maintain a net capital of more than 25,000 dollars to support that indebtedness and comply with the ratio rule. But if aggregate indebtedness was less than 500,000 dollars, *i.e.*, less than twenty times greater than 25,000 dollars, he would be subject to the minimum net capital requirement and would have to maintain a fixed level of 25,000 in minimum net capital.

*2. NYSE's Definition of Net Capital and Aggregate Indebtedness.*—Rule 325's definition of "aggregate indebtedness" and "net capital" closely parallels that of rule 15c3-1. "Aggregate indebted-

[77] NYSE Rule 325(a), 2 NYSE Guide ¶ 2325.
[78] *Ibid.*

ness" is defined under rule 325 as the total money liabilities of a broker-dealer with specified exclusions such as liabilities adequately collateralized, liabilities subordinated by a satisfactory subordination agreement to the claims of general creditors, liabilities on open contractual commitments, and numerous other exclusions that accord with the SEC's rule.[79] "Net capital's" definition also conforms with that found under rule 15c3-1. It is defined under rule 325 as net worth less such items as fixed assets, prepaid rent, assets not readily convertible into cash, and so on.[80] However, the definition does differ in one major respect in that it requires greater "haircuts" than the SEC's rule. For example, it prescribes a thirty per cent "haircut" on all securities in inventory positions instead of the SEC's varying "haircuts" of five to thirty per cent.[81] Also, percentage deductions from federal and state government securities are required whereas no such deduction is imposed by rule 15c3-1. These deductions decrease as the bonds approach maturity, ranging from zero per cent with less than one year to maturity to ten per cent with five years or more to maturity.[82] Moreover, the amount of "haircut" deduction on securities not held in inventory may depend on the quality of the security. As an illustration, in the case of a non-convertible bond, the percentage deduction may vary from five per cent to fifteen per cent, depending on the rating given the bond by a nationally known statistical service such as Standard and Poor or Moody's.[83] The SEC's rule does not inquire into the quality of the security.

It should be emphasized that the definition of "net capital" applies to both the net capital-to-indebtedness ratio rule and the minimum net capital rule. Hence, when rule 325 speaks of requiring a minimum net capital of 25,000 dollars or 50,000 dollars, this refers to a level of net worth reduced by such items as "haircut" deductions.

*3. Remedy for Violation of Rule 325.*—The NYSE remedy for violation of its ratio rule or minimum net capital requirement is to suspend trading privileges.[84] In light of the prestige and large customer market this privilege brings, the remedy would appear to

[79] NYSE Rule 325(b)(2)(A)-(H), 2 NYSE Guide ¶ 2325.
[80] NYSE Rule 325(b)(4)(A)-(I), 2 NYSE Guide ¶ 2325.
[81] NYSE Rule 325(b)(4)(B), (C), 2 NYSE Guide ¶ 2325.
[82] NYSE Rule 325(c)(1)(A), (B), 2 NYSE Guide ¶ 2325.
[83] NYSE Rule 325(c)(4)-(6), 2 NYSE Guide ¶ 2325.
[84] NYSE Const. art. XIV, §§ 6, 7, 2 NYSE Guide ¶¶ 1656, 1657.

be most effective in thwarting violations of rule 325. However, the argument can be made that this remedy may add to the difficulties of a broker-dealer firm in a precarious liquidity position and harm the customers by forcing an insolvency. The NYSE is able to detect violations by surprise audits.[85]

*4. Unannounced Policies of NYSE.*—In addition to the above two rules,

> the NYSE has certain unpublished policies which have the effect of rules. While the 20:1 rule is the formal requirement of the exchange, on occasion, when a firm has come close to this level, the exchange staff has recommended to the firm that in the future it should maintain a ratio of aggregate indebtedness to net capital of 17.5:1. Likewise, the exchange staff at times will bring to bear pressure on its members to keep inventories of securities at a value of not more than ten times excess net capital, i.e., the excess of the broker-dealer's net capital over the capital required to support its aggregate indebtedness.[86]

These policies appear to be specifically authorized by rule 325, for it provides: "The Exchange may at any time . . . in the case of a particular member . . . prescribe greater requirements than those prescribed herein."[87]

*5. Fidelity Bond.*—The NYSE recently instituted a requirement under rule 319 that all member broker-dealers doing business with the public or other members carry fidelity bonds covering the broker-dealers' general partners, officers, and employees.[88] These bonds indemnify member broker-dealers from losses resulting from dishonest or careless acts of officers and employees, such as theft, embezzlement, loss or misplacement of property, check forgery, or fraudulent trading. Although the bond does not confer a right of action directly on the customer who may be adversely affected by such acts, it does serve indirectly as a protection to the public investor since the bond proceeds would add to the broker-dealer's assets and might prevent or ameliorate bankruptcy.[89] The required minimum coverage of the bond varies with the type of business done by the member broker-dealer and with the amount of net capital he must have to support his aggregate indebtedness. For

[85] See NYSE Rule 418, 2 NYSE Guide ¶ 2418.
[86] Special Study, pt. 1, at 408-09.
[87] NYSE Rule 325(a), 2 NYSE Guide ¶ 2325.
[88] NYSE Rule 319, 2 NYSE Guide ¶ 2319.
[89] Note, 77 HARV. L. REV. 1290, 1293 (1964).

example, for broker-dealers who do business with other members of the exchange and do not carry customers accounts, the minimum coverage required is 100,000 dollars. For broker-dealers who carry customers' accounts and do business with the public, the minimum coverage changes with the net capital required under the ratio rule, ranging from a 200,000 dollar minimum coverage where the net capital required is 50,000 dollars to 5 million dollars where the net capital required is 12 million dollars.[90]

*6. Central Indemnification Fund.*—In 1964, the NYSE approved amendments to its constitution that have the effect of providing even greater safeguards for customers of member broker-dealer firms. These amendments provide for a permanent central indemnification fund totaling 25 million dollars for repaying customers of a member broker-dealer that becomes insolvent.[91] This protection was triggered by the collapse of Ira Haupt & Co. When Haupt failed, the firm was holding for customers approximately 9 million dollars in cash and 490 million dollars in securities. The Exchange took the lead in liquidating Haupt, spending 9.5 million dollars of its own funds to repay customers who had left securities with the firm. It then levied on its members a special assessment.[92] The amendments soon followed.

*7. Other Exchanges.*—Discussion here will be limited to those major regional exchanges that have been exempted from rule 15c3-1 because their requirements are more comprehensive. The requirements of these exchanges are more comprehensive in several respects. First, the net capital-to-aggregate indebtedness ratios are stricter on some exchanges.[93] Second, all of the exchanges exempted from coverage by rule 15c3-1 have minimum net capital maintenance requirements in addition to ratio rules. The American Stock Exchange requires of member broker-dealers having public customers a minimum net capital of 50,000 dollars, and of those without public customers a net capital of 25,000 dollars; the Boston Stock Exchange requires members to maintain a minimum net capital of 25,000 dollars; the Midwest Stock Exchange requires

[90] NYSE Rule 319, 2 NYSE Guide ¶ 2319.
[91] NYSE Const. art. X, § 9, 2 NYSE Guide ¶ 1459.
[92] Wall Street Journal, July 31, 1964, p. 6, col. 3.
[93] The maximum permissible ratios of the Midwest and Pittsburgh stock exchanges are 15:1 rather than the SEC's 20:1 ratio. Special Study, pt. 1, at 408.

corporate members to have a net capital of 25,000 dollars, whereas individuals must have net capital of 10,000 dollars; the Pacific Coast Stock Exchange requires its members doing business with the public to maintain a minimum net capital in an amount at least 5,000 dollars in excess of five per cent of aggregate indebtedness, or not less than 25,000 dollars, whichever is greater. Similar requirements are in force on the other exchanges exempted from rule 15c3-1.[94] Third, the "haircut" requirements of the exempted exchanges are more comprehensive. A prime example of this is the "haircut" requirements of the Midwest Stock Exchange, where government issues, both federal and state, have a two and one half per cent "haircut," whereas rule 15c3-1 requires no "haircut" on such securities. Also, it prescribes a flat thirty per cent "haircut" on all securities in inventory instead of the Commission's varying "haircuts" of five to thirty per cent. Finally, the rules of this exchange provide that "inactive securities" may be discounted in a greater amount than thirty percent, *i.e.*, if a broker-dealer keeps a class of securities in his inventory for a substantial length of time, a higher "haircut" will be required.[95] No comparable rule is found in federal broker-dealer requirements.

### *B. National Association of Securities Dealers*

*1. Membership.*—Membership in the NASD is not required by the SEC,[96] although it has proposed that membership be made compulsory for all broker-dealers engaged in an interstate over-the-counter business.[97] Even though membership is not compulsory, of the approximately 6,000 broker-dealer firms actively engaging in the over-the-counter business only about 620 firms are not mem-

[94] *Id.* at 408.

[95] Halsted, *Rules and Regulations of Midwest Stock Exchange,* 1961 U. ILL. L.F. 257, 258.

[96] In 1938, Congress passed the Maloney Act, which amended the Exchange Act of 1934 by expressly authorizing the voluntary formation by over-the-counter broker-dealers of "national securities associations." Act of June 23, 1938, 52 Stat. 1070, 15 U.S.C. § 78o-3 (1958). A national securities association may be registered with the SEC if it adopts rules for the regulation of its members that conform to certain requirements, such as demonstrating to the SEC that "such association will be able to comply with the provisions of this title [the Exchange Act]. . . ." 78 Stat. 574 (1964), 15 U.S.C. § 78o-3(b)(1) (Supp. 1964). The NASD is the only association registered with the SEC, and since 1939, it has been the major self-regulatory arm of the over-the-counter business.

[97] Special Study, pt. 1, at 159. The proposal was rejected by Congress when it enacted the 1964 amendments without such a requirement.

bers of the NASD; the bulk of the nonmembers are broker-dealers engaged in issues not considered to be securities, such as oil royalties and savings and loan shares.[98]

*2. Pre-1964 Amendments.*—Before the 1964 amendments to the Exchange Act, the fundamental philosophy of the act was one of free entry by broker-dealers into the over-the-counter business. This philosophy was evident in the lenient requirements for membership in the NASD, which in effect allowed membership in the association if broker-dealers conducted an honest and responsible business.[99] Accordingly, although the NASD enforced the SEC's rule 15c3-1, it did not have any minimum capital or bonding requirements on which it could have based a refusal to grant membership.[100] Previous attempts by the NASD to impose such requirements had been opposed by the SEC as inconsistent with congressional intent that NASD membership be open to anyone conducting an honest and responsible business. The SEC felt that such a rule would result in the expulsion of over one-fourth of the association's membership and restrict it to the larger broker-dealer concerns.[101]

*3. The 1964 Amendments.*—The 1964 amendments to the Exchange Act abandoned this philosophy of free-entry, because of congressional belief that it made entry too easy for the inexperienced and unqualified broker-dealer.[102] The result is that Congress has now provided the NASD with broad authority to impose stricter requirements for membership. Section 15A(b)(5) authorizes and requires the NASD to prescribe rules barring from membership any broker-dealer that does not meet "specified and appropriate" requirements with respect to the financial responsibility of such member.[103] It provides that a national securities association will not be registered with the SEC unless it appears to the Commission that "the rules of the association provide . . . no person shall become a member . . . unless such person is qualified to become a member in conformity with specified and appropriate standards with respect to . . . the financial responsibility of such member."[104] This new authority will in all

[98] LEFFLER, THE STOCK MARKET 405 (3d ed. 1963).
[99] SORG PRINTING CO., SECURITIES ACT AMENDMENTS OF 1964 WITH EXPLANATION 31 (1964).
[100] Special Study, pt. 1, at 86.
[101] National Ass'n of Sec. Dealers, Inc. v. SEC, 12 S.E.C. 322, 325 (1942).
[102] SORG PRINTING CO., *op. cit. supra* note 99, at 31.
[103] 78 Stat. 574, 15 U.S.C. § 78o-3(b)(5) (Supp. 1964).
[104] 78 Stat. 574, 15 U.S.C. § 78o-3(b)(5) (Supp. 1964).

probability result in the adoption of a minimum net capital requirement for broker-dealers as a condition of membership in the NASD. The amount of such a requirement is difficult to forecast. However, in view of the new provision that NASD rules may classify prospective members by taking into account their type of business,[105] it appears unlikely that there will be a uniform minimum capital requirement for all NASD members. Account will probably be made for size of the broker-dealer, number of employees, or the type of business the broker-dealer engages in. Any indication of what the exact dollar amounts will be can only be had from the *Special Study* recommendations.[106]

*4. Disciplinary Powers.*—The Exchange Act provides that an association cannot be registered as a national securities association unless "the rules of the association provide that its members . . . shall be appropriately disciplined, by expulsion, suspension, fine, censure, . . . or any other fitting penalty, for violation of its rules."[107] The NASD has established such power.[108] Thus, if the NASD does adopt a minimum net capital rule, it will have effective sanctions against a member broker-dealer for violation of such a rule as it does now for members who violate rule 15c3-1.

*5. "Mirror" Provision.*—As noted above, Congress rejected the SEC's proposal that all broker-dealers engaged in interstate over-the-counter business be required to join the NASD. However, by the enactment of a new section, 15(b)(8),[109] Congress has provided for regulation of broker-dealers who refuse to join the NASD. This regulation is comparable to that which the NASD is authorized and required to adopt under section 15A(b)(5) for its members. The new law provides that, even though a registered broker-dealer is not a member of the NASD, he may not engage in the over-the-counter business unless he meets standards relating to training, experience, and other necessary and desirable qualifications as the SEC may prescribe. The point to be noted here is that, while the SEC has been given power to provide standards and rules for broker-dealers who are not members of the NASD that largely "mirror"

[105] 78 Stat. 574, 15 U.S.C. § 78o-3(b)(5)(A) (Supp. 1964).
[106] See text accompanying notes 53-59 *supra*.
[107] 78 Stat. 574, 15 U.S.C. § 78o-3(b)(9) (Supp. 1964).
[108] NASD Rules of Fair Practice, art. VII, § 3(c), NASD Manual at C-40 (1962).
[109] 78 Stat. 570 (1964), 15 U.S.C. § 78o(b)(8) (Supp. 1964).

those given to the association, the new provision makes no mention of standards of financial responsibility for nonmember broker-dealers. As seen above, however, the NASD has been given express authority to establish standards of financial responsibility for member broker-dealers. The reason for this difference is that Congress felt that, in view of the authority already established in the SEC under section 15(c)(3) to provide safeguards with respect to financial responsibility, "it was unnecessary to mention this power again in connection with the new power of the SEC to provide other qualification standards for nonmembers."[110]

## III. Regulation by the States

At present there are thirty-four states that have enacted blue-sky provisions to assure the financial responsibility and stability of broker-dealers. These states impose upon broker-dealers within their jurisdiction either net capital-to-indebtedness ratio requirements, minimum net capital rules, and/or bonding requirements, all of which apply both as conditions to entry and as continuous operational requirements after entry. Although the blue-sky provisions vary significantly from state to state, six patterns can be derived:

(1) Those states imposing bonding requirements solely. There are fifteen states in this class. They are (with the dollar amount of the bond required): Alaska (up to 10,000 dollars),[111] Arizona (up to 25,000 dollars),[112] California (5,000 dollars),[113] Florida (5,000 dollars),[114] Hawaii (5,000 dollars),[115] Indiana (25,000 dollars),[116] Iowa (5,000 dollars),[117] Maine (10,000 dollars),[118] Michigan (up to 100,000 dollars),[119] Missouri (5,000 dollars),[120] Nebraska (discretionary),[121] North Dakota (discretionary),[122] Oregon (10,000

[110] Sorg Printing Co., *op. cit. supra* note 99, at 38.
[111] Alaska Comp. Laws Ann. § 45.55.040 (1962). See also Blue Sky L. Rep. ¶ 6046.
[112] Ariz. Rev. Stat. Ann. § 44-1943 (1956).
[113] Cal. Corp. Code § 25703.
[114] Fla. Stat. Ann. § 517.12(4) (1962).
[115] Hawaii Rev. Stat. § 199-11(c) (Supp. 1960).
[116] Ind. Ann. Stat. § 25-839(2) (1960).
[117] Iowa Code Ann. § 502.18 (1949).
[118] Me. Rev. Stat. Ann. ch. 59, § 229 (Supp. 1963).
[119] Mich. Stat. Ann. § 19,762 (1964).
[120] Mo. Rev. Stat. Ann. § 409.140 (1952).
[121] Neb. Rev. Stat. § 81.321 (1958).
[122] N.D. Cent. Code § 10-04-10 (Supp. 1963).

dollars),[123] South Dakota (5,000 to 15,000 dollars),[124] and Vermont (1,000 to 25,000 dollars).[125]

(2) Those states imposing minimum net capital requirements solely. There are three states in this class. They are (with the respective amounts required): New Hampshire (25,000 dollars),[126] New York (10,000 dollars),[127] and Pennsylvania (25,000 dollars).[128]

(3) Those states imposing minimum net capital and bonding requirements. This class includes seven states: Arkansas (minimum net capital of 12,500 dollars and bond of 5,000 and up to 50,000 dollars),[129] Colorado (minimum net capital of 10,000 dollars and bond up to 10,000 dollars),[130] Georgia (minimum net capital of 100,000 dollars and bond of 10,000 dollars),[131] Kentucky (minimum net capital of 10,000 dollars and bond up to 10,000 dollars),[132] Oklahoma (minimum net capital of 10,000 dollars and bond of 10,000 dollars),[133] South Carolina (minimum net capital up to 10,000 dollars and bond of 10,000 dollars), [134] and Utah (minimum net capital discretionary and bond of 10,000 dollars).[135]

(4) Those states imposing minimum net capital or bonding requirements. These states require a bond only if net capital is below a prescribed amount. This class includes four states: Alabama (minimum net capital of 25,000 dollars or bond up to 10,000 dollars),[136] Minnesota (minimum net capital of 15,000 dollars or bond of 15,000 dollars),[137] New Jersey (minimum net capital of

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[123] ORE. REV. STAT. § 59.310(7) (1963).
[124] S.D. CODE § 55.1912 (1960).
[125] VT. STAT. ANN. tit. 9, § 4216 (1958).
[126] N.H. Reg. 2, 2 BLUE SKY L. REP. ¶ 32610, promulgated under N.H. REV. STAT. ANN. ch. 421 (1955).
[127] N.Y. GEN. BUS. LAW § 352-K.
[128] Pa. Reg. 1501, 2 BLUE SKY L. REP ¶ 41302, promulgated under PA. STAT. ANN. tit. 70, § 57 (Supp. 1964).
[129] 1 BLUE SKY L. REP. 1704.
[130] COLO. REV. STAT. §§ 125-10-4(4), (5) (Supp. 1961).
[131] Ga. Reg. 2(d)(2), 1 BLUE SKY L. REP. ¶ 14303, promulgated under GA. CODE ANN. tit. 97, § 105(f) (Cum. Supp. 1963).
[132] KY. REV. STAT. §§ 292.300(3)(b), (c) (1962).
[133] Okla. Rules 59-1 and 64-14, 2 BLUE SKY L. REP. ¶¶ 39605, 39639, promulgated under OKLA. STAT. ANN. tit. 71, §§ 202(d), (e) (Cum. Supp. 1964).
[134] S.C. CODE §§ 62-110, 111 (1962).
[135] UTAH CODE ANN. §§ 61-1-4(4), (5) (Supp. 1963).
[136] ALA. CODE tit. 53, § 29(c) (Cum. Supp. 1963).
[137] Minn. Reg. VIII, 2 BLUE SKY L. REP. ¶ 26608, promulgated under MINN. STAT. ANN. § 80.12(2) (Cum. Supp. 1964).

25,000 dollars or bond of 25,000 dollars),[138] Ohio (minimum net capital of 10,000 dollars or bond discretionary),[139] and Virginia (minimum net capital of 25,000 dollars or bond of 25,000 dollars).[140]

(5) States imposing bonding and net capital-to-indebtedness ratio requirements. There is only one state in this class: Mississippi (ratio requirement of 20:1 and bond of 5,000 dollars).[141]

(6) Those states imposing net capital-to-indebtedness ratio requirements, minimum capital requirements, and bonding requirements. This class includes three states: Kansas (minimum net capital of 10,000 dollars, ratio requirement of 20:1, and bond of 5,000 dollars),[142] Maryland (minimum net capital of 15,000 dollars, ratio requirement of 20:1, and bond up to 10,000 dollars),[143] and New Mexico (minimum net capital of 5,000 dollars, ratio requirement of 20:1, and bond up to 100,000 dollars).[144]

### *A. Bonding Requirements*

The bonds required by any of the above states, either as the sole requirement or in conjunction with a net capital-to-indebtedness ratio requirement or a minimum net capital requirement, are surety bonds and typically permit an aggrieved person to sue directly on the bond for violation by the bonded broker-dealer of civil liabilities provisions of the applicable blue-sky law. In fact, the bonds are conditioned on strict compliance with the blue-sky laws.[145] The bonds are required before the broker-dealer can register and thus conduct his business within the state, and usually run to the state for the benefit of aggrieved persons. The sureties required on the bond must be approved by the state.[146]

It should be noted that these bonds differ from the fidelity bonds required by rule 319 of the NYSE in that the fidelity bond

[138] N.J. STAT. ANN. § 49:3-1-(e) (Cum. Supp. 1964).
[139] Ohio Reg. DS-4, 2 BLUE SKY L. REP ¶ 38664, promulgated under OHIO CODE ANN. § 1707.20 (1964).
[140] VA. CODE ANN. § 13.1-505(b) (1964).
[141] Miss. Rule D-5, 2 BLUE SKY L. REP. ¶ 27651, promulgated under MISS. CODE ANN. §§ 5373, 5368 (Cum. Supp. 1962).
[142] Kan. Regs. 81-17-1, D, 3A and 3B, 1 BLUE SKY L. REP ¶ 19703, promulgated under KAN. GEN. STAT. ANN. §§ 17-1254(c), 1270(f) (1961).
[143] MD. CODE ANN. art. 32A, §§ 16(d), (e) (Cum. Supp. 1964).
[144] N.M. STAT. ANN. §§ 48-18-20.2, 20.3 (Supp. 1963).
[145] *E.g.*, ARIZ. REV. STAT. ANN. § 44-1943 (1956).
[146] *E.g.*, CAL. CORP. CODE § 25703.

does not confer a right of action directly on the customer,[147] whereas the surety bonds required by state blue-sky laws do. However, there is a limitation on this right, as most blue-sky laws demand that the action be brought within two years from the time the act complained of occurred.[148]

All of the states requiring bonds provide that deposits of cash or securities will be accepted in lieu of such bonds.[149] Also, most of the states that require bonds do so regardless of a broker-dealer's net capital.[150] But a few states demand a bond only in the event that a broker-dealer's net capital, as defined in the statute or by appropriate regulation, is less than a given amount.[151] Furthermore, the bonds required are usually for a determined amount; but a few states leave the amount of the bond to the discretion of their commissioner of securities laws, who is to base his decision on such factors as the financial condition of the broker-dealer[152] or the volume of business and number of salesmen employed.[153] However, even though the bond required may be for a determined amount, the amount may vary within a prescribed range, depending on the number of salesmen a broker-dealer has.[154]

Clearly, the surety bonds required by a majority of the states assure the financial responsibility of the broker-dealer at least to the extent of the face value of the bond, because they allow only broker-dealers with a substantial amount of money to pay for the bonds (and who are able to get sureties) to enter into the business. Furthermore, they prevent a broker-dealer from being judgment proof when suit is brought for any violation of the civil liabilities sections of the respective blue-sky laws.

### *B. Minimum Net Capital Requirements*

The minimum net capital requirements, which are imposed either as the sole requirement or in conjunction with a net capital-to-indebtedness ratio requirement or a bonding requirement, appear in varying forms with respect to the dollar amounts required. A

[147] See NYSE Rule 319, 2 NYSE Guide ¶ 2319.
[148] *E.g.*, COLO. REV. STAT. § 125-10-4(4) (Supp. 1961).
[149] *E.g.*, FLA. STAT. ANN. § 517.14 (1962).
[150] *E.g.*, S.C. CODE § 62-111 (1962).
[151] *E.g.*, ALA. CODE tit. 53, § 29(c) (Cum. Supp. 1963).
[152] *E.g.*, S.D. CODE § 55.1912 (1960).
[153] *E.g.*, N.D. CENT. CODE § 10-04-10 (Supp. 1963).
[154] 1 BLUE SKY L. REP. ¶ 1704.

majority of the blue-sky laws prescribe 10,000 dollars or 15,000 dollars as the necessary level of minimum net capital. Georgia requires the highest level of minimum net capital—100,000 dollars.[155] A few states provide for more than one level of minimum net capital.[156]

Most states fail to define the term "minimum net capital" ("minimum capital" in the words of several blue-sky laws), thus creating the presumption that minimum net capital simply means a level of cash that is required to be maintained by the broker-dealer. However, a few states have defined the phrase either by using their own terminology[157] or by using the same terms that define "net capital" under the SEC's rule 15c3-1.[158] The few states that define minimum net capital do so by regulations or rules rather than by the enabling statute itself. Such a method is essential in light of the technical nature of minimum net capital rules.

### *C. Net Capital-to-Indebtedness Ratio Requirement*

The four states[159] imposing a net capital-to-indebtedness ratio requirement in conjunction with minimum net capital and/or bonding provisions all prescribe a 20:1 ratio. The terms "net capital" and "aggregate indebtedness" are defined in the statutes of the respective states by using the terminology of rule 15c3-1.

### *D. Relief for Violation of Blue-Sky Provisions*

The forms of relief available for violation of the above provisions are fairly uniform throughout the states and roughly parallel those found under the Exchange Act of 1934. First is suspension or revocation of registration;[160] second is injunctive relief.[161] Fine and/or imprisonment is a third possible form of relief, one not

[155] Ga. Reg. 2(d)(2), 1 BLUE SKY L. REP ¶ 14303, promulgated under GA. CODE ANN. tit. 97, § 105(f) (Cum. Supp. 1963).

[156] For example, in New Mexico a broker-dealer must have a minimum of 10,000 dollars upon registration, but once registered, only 5,000 dollars. N.M. Order 61-421B, 2 BLUE SKY L. REP. ¶ 34613, promulgated under N.M. STAT. ANN. § 48-18-20.2 (Supp. 1963).

[157] *E.g.*, N.M. Order 61-421G, 2 BLUE SKY L. REP. ¶ 34613, promulgated under N.M. STAT. ANN. § 48-18-20.2 (Supp. 1963).

[158] *E.g.*, Okla. Rule 64-14, 2 BLUE SKY L. REP. ¶ 39639, promulgated under OKLA. STAT. ANN. tit. 17, § 202(d) (Cum. Supp. 1964).

[159] Kansas, Maryland, Mississippi, and New Mexico. See notes 141-44 *supra* and accompanying text.

[160] *E.g.*, N.J. STAT. ANN. § 49:3-11(a) (Cum. Supp. 1964).

[161] *E.g.*, KY. REV. STAT. § 292.470 (1962).

available under federal securities law.[162] However, the majority of the states require that the broker-dealer had knowledge of the provision or rule before there can be any fine or imprisonment for its violation.[163]

Most blue-sky laws provide for periodic examinations of broker-dealers' records and financial statements.[164] Thus, violations can be readily detected.

### *E. An SEC Ruling*

In 1963, the SEC advised broker-dealers in New York that a violation of a New York statute that specified a minimum net capital requirement would be considered a violation of the anti-fraud provisions.[165] The ruling goes beyond the scope of state regulation because the majority of states do not provide for civil liability for violating capital requirements. Thus, a result unintended by the states may result from the operation of their laws. Whether the ruling will be enforced is unknown, but it will undoubtedly serve as a warning to those in the business.

### *F. North Carolina*

North Carolina does not specifically provide for bonding, minimum capital, or net capital-to-indebtedness ratio requirements. The only provision expressly dealing with the financial responsibility of broker-dealers provides that the Secretary of State may cancel the registration of a broker-dealer if the broker-dealer is insolvent or in danger of insolvency.[166] However, it requires registration with the SEC as a prerequisite for registration in the state. This requirement subjects broker-dealers in North Carolina to rule 15c3-1 and thus assures financial responsibility of broker-dealers, at least by present federal standards.

### *G. Uniform Securities Act*

The Uniform Securities Act contains two provisions directed toward the financial responsibility of broker-dealers. The first is section 202(d), which provides: "The [Administrator] may by rule require a minimum capital for registered broker-dealers."[167]

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[162] 48 Stat. 904 (1934), 15 U.S.C. § 78ff(c) (1958).
[163] *E.g.*, MD. CODE ANN. art. 32A, § 33(a) (Cum. Supp. 1964).
[164] *E.g.*, S.C. CODE § 62-120 (1962).
[165] CCH FED. SEC. L. REP. ¶ 76927 (1963).
[166] N.C. GEN. STAT. § 78-19 (1965).
[167] UNIFORM SECURITIES ACT § 202(d).

No net capital to aggregate indebtedness ratio is provided for. However, the Official Comment to section 202(d) states that any state that adopts the act and wants to prescribe such a ratio may do so by adding at the end of section 202(d): "or prescribe a ratio between net capital and aggregate indebtedness."[168] Any definition of the terms "minimum capital" or "ratio between net capital and aggregate indebtedness" is left to section 412(a), which provides: "The [Administrator] may from time to time make . . . such rules . . . as are necessary to carry out the provisions of this act . . . ."[169] Such a relegation of the definition of these terms to administrative rules or regulations is essential in view of their technical nature.

The second provision, section 202(e), relates to the posting of surety bonds by broker-dealers:

> The [Administrator] may by rule require registered broker-dealers, to post surety bonds in amounts up to 10,000 dollars, and may determine their conditions. Any appropriate deposit of cash or securities shall be accepted in lieu of any bond so required. No bond may be required of any registrant whose net capital, which may be defined by rule, exceeds 25,000 dollars. Every bond shall provide for suit thereon by any person who has a cause of action under section 410 [section dealing with civil liabilities under the act], and if the [Administrator] by rule or order requires, by any person who has a cause of action not arising under this act. Every bond shall provide that no suit may be maintained to enforce any liability on the bond unless brought within two years after . . . the act upon which it is based.[170]

The Official Comment to section 202(e) states that the administrator has no discretion whether to accept a deposit of cash or securities in lieu of a bond but that he has discretion to ascertain if the amount of the deposit and the type of securities deposited are proper.[171] Many of the previously discussed blue-sky provisions relating to the requirements of posting bond are similar to section 202(e).

## IV. Conclusion

Among 215 new broker-dealers registering with the SEC in a six month period in 1956, twenty-seven per cent had net capital of

[168] Loss & Cowett, Blue Sky Law 265 (1958).
[169] Uniform Securities Act § 412(a).
[170] Uniform Securities Act § 202(e).
[171] Loss & Cowett, *op. cit. supra* note 168, at 266.

less than 1,000 dollars.[172] Hence, the present pattern of federal regulation of the financial responsibility of broker-dealers is inadequate. More than a net capital-to-aggregate indebtedness ratio is needed; a minimum net capital rule should be adopted. As recently as November 22, 1964, the SEC announced that such a rule is to be formally proposed within a short time.[173] Therefore, barring successful opposition to its adoption, a minimum net capital requirement will soon exist, and adequate protection of the investing public will be further assured.

With the adoption of a minimum net capital rule by the NASD, the regulation of the financial responsibility of broker-dealers by the self-regulatory bodies will likewise become adequate; the pattern of regulation by the stock exchanges is already sufficient.

While adoption of the pertinent provisions of the Uniform Securities Act is recommended, it appears unlikely that many states will provide this further assurance of financial responsibility in the near future. However, any concern over the lack of sufficient assurances by the states is mitigated by the extensive regulation by federal and self-regulatory bodies.

BARRY A. OSMUN

**Conflicts—Most Significant Relationship Rule**

Decedent, a domiciliary of Pennsylvania, purchased a ticket in Pennsylvania from an air line, a Delaware corporation with principal offices in Illinois, for a flight from Pennsylvania to Arizona. The plane crashed while landing at a scheduled stop in Colorado, causing the decedent's immediate death. The executor of his estate brought an action against the air line in Pennsylvania for breach of contract of carriage, seeking recovery under Pennsylvania's law of damages which allowed recovery for decedent's probable earnings during the period of his life expectancy.[1] The lower court sustained the contract action, but denied recovery under Pennsylvania's law of damages, holding that the law of the

[172] Special Study, pt. 1, at 85.
[173] N.Y. Times, Nov. 23, 1964, p. 59, col. 5.

[1] See, *e.g.*, Skoda v. West Penn Power Co., 411 Pa. 323, 335, 191 A.2d 822, 828-29 (1963).

place of wrong, Colorado, controlled. A Colorado statute denied recovery for prospective earnings after death.[2] The Supreme Court of Pennsylvania, in *Griffith v. United Air Lines, Inc.*,[3] reversed and held that Pennsylvania's law of damages should govern. The court first concluded that negligence rather than contract principles should be applied because the contract characterization ignored the realities of the situation. The court then overruled the state's traditional choice of law rule for personal injuries, which required the application of the law of the place of wrong,[4] and formulated a more flexible rule that permits analysis of the interests and policies of the states involved in determining which jurisdiction's law should apply.

The traditional choice of law rule for tort actions, previously followed in Pennsylvania and embodied in the first *Restatement*,[5] is the *lex loci delicti* principle that the substantive rights and liabilities of the parties are determined by the law of the place of wrong.[6] This rule has been justified by the vested rights doctrine,[7] under which the rights and obligations incurred under the law of the jurisdiction where the wrong occurs[8] are said to vest in the parties and follow them into any jurisdiction in which suit is brought.[9] The forum, or court in which suit is brought, ascertains "the place

[2] COLO. REV. STAT. ANN. § 152-1-9 (Perm. Cum. Supp. 1960). See also COLO. REV. STAT. ANN. § 41-1-3 (Perm. Cum. Supp. 1960), which limits recovery to an amount not exceeding $25,000 in a cause of action based on a wrongful act.

[3] 416 Pa. 1, 203 A.2d 796 (1964).

[4] See, *e.g.*, Vant v. Gish, 412 Pa. 359, 365-66, 194 A.2d 522, 526 (1963); Bednarowicz v. Vetrone, 400 Pa. 385, 162 A.2d 687 (1960); Rennekamp v. Blair, 375 Pa. 620, 101 A.2d 669 (1954); Rodney v. Staman, 371 Pa. 1, 89 A.2d 313 (1952).

[5] RESTATEMENT, CONFLICT OF LAWS § 384 (1934): "(1) If a cause of action in tort is created at the place of wrong, a cause of action will be recognized in other states. (2) If no cause of action is created at the place of wrong, no recovery in tort can be had in any other state." See generally GOODRICH, CONFLICT OF LAWS § 92 (4th ed. 1964).

[6] *Ibid.*

[7] See 2 BEALE, CONFLICT OF LAWS §§ 377-92 (1935); STUMBERG, CONFLICT OF LAWS 8 (3d ed. 1963).

[8] RESTATEMENT, CONFLICT OF LAWS § 377 (1934): "The place of wrong is in the state where the last event necessary to make an actor liable for an alleged tort takes place."

[9] Slater v. Mexican Nat'l R.R., 194 U.S. 120 (1904) (Holmes, J.). "The theory of foreign suits is that the act complained of was subject to no law having force in the forum, it gave rise to an obligation, an *obligatio*, which, like other obligations, follows the person, and may be enforced wherever the person be found." *Id.* at 126.

where a right arose and the law that created it . . ."[10] and applies that law to the particular case, thus giving effect to a foreign created right through the forum's law of conflicts—in this case the *lex loci delicti* rule.[11] The first *Restatement* recognized two exceptions to the rule: the forum applies its own procedural rules,[12] and the forum applies its own law when the law of the place of wrong is contrary to a strong public policy of the forum.[13]

Because of the long-standing adherence to the predictable and uniform rules of the first *Restatement,* forums are reluctant to overrule them even when their application produces an unjust result. To avoid abrogation of the place of wrong rule and yet reach equitable results, some forums have devised avenues of escape, technically within the first *Restatement's* rules, by which they apply law other than that of the place of wrong. Since the first *Restatement* recognized that the forum applied its own rules of procedure,[14] some courts seeking to avoid applying the law of the place of wrong have characterized substantive problems before them as procedural, and thus subject to the law of the forum.[15] For example, one forum characterized survival of a cause of action not as an essential part of the cause of action, but rather as a matter of enforcement of the claim for damages, and hence a procedural question subject to the law of the forum.[16] Other courts have characterized actions

[10] 1 BEALE, *op. cit. supra* note 7, § 8A.8.

[11] RESTATEMENT, CONFLICT OF LAWS §§ 1, 5 (1934).

[12] *Id.* § 585. See EHRENZWEIG, CONFLICT OF LAWS §§ 124-25 (1962); STUMBERG, *op. cit. supra* note 7, at 133, 154-55.

[13] RESTATEMENT, CONFLICT OF LAWS § 612 (1934). See, *e.g.,* Gordon v. Parker, 83 F. Supp. 40 (D. Mass. 1949); Thome v. Macken, 58 Cal. App. 2d 76, 136 P.2d 116 (1949) (cause of action for alienation of affections against forum's public policy); Kilberg v. Northeast Airlines, Inc., 9 N.Y.2d 34, 172 N.E.2d 526, 211 N.Y.S.2d 133 (1961) (limitation on damages in place of wrong against forum's public policy). See generally Paulsen & Sovern, *Public Policy in Conflict of Laws,* 56 COLUM. L. REV. 969 (1956).

[14] See note 12 *supra.*

[15] See Kilberg v. Northeast Airlines, Inc., 9 N.Y.2d 34, 42, 172 N.E.2d 526, 529, 211 N.Y.S.2d 133, 137 (1961) (damage limitation classified as procedural; see note 13 *supra* for an alternative basis for applying the forum's law). *Contra,* Slater v. Mexican Nat'l R.R., 194 U.S. 120, 126 (1904) (damage limitation considered a substantive matter); Northern Pac. R.R. v. Babcock, 154 U.S. 190 (1894). *But see* Davenport v. Webb, 11 N.Y.2d 392, 183 N.E.2d 902, 230 N.Y.S.2d 17 (1962) (subsequent decision withdrawing the procedural classification in *Kilberg*).

[16] Grant v. McAuliffe, 41 Cal. 2d 859, 866, 264 P.2d 944, 949 (1953). *Contra,* RESTATEMENT, CONFLICT OF LAWS § 390 (1934), which considers survival of a cause of action to be a substantive matter governed by the

essentially sounding in tort as questions of contract law to avoid the place of wrong rule.[17] On the other hand, some courts have found exception to the place of wrong rule and have formulated specific new choice of law rules in tort actions involving questions of intrafamilial immunity from tort liability,[18] decedent's estates law,[19] and workmen's compensation,[20] in order to apply the law of a jurisdiction other than that of the place where the wrong occurred. For example, one forum characterized an action involving interspousal immunity from tort liability as family law to be governed by the law of the domicile of the parties, which, in this case, was the forum.[21] Other courts have ignored the place of wrong rule and applied the forum's statutory liability for a certain act where the law of the place of wrong imposed no such liability.[22]

The results reached by these courts have been said to be desirable, but the means of reaching them have been criticized.[23] Many commentators have advocated abolition of the first *Restate-*

law of the place of wrong. For an alternative basis of *McAuliffe,* see note 19 *infra.*

[17] See Dyke v. Eire Ry., 45 N.Y. 133 (1871) (personal injury action arising out of train accident characterized as breach of contract).

[18] See Emery v. Emery, 45 Cal. 2d 421, 289 P.2d 218 (1955) (unemancipated minor permitted to recover from parent under law of domicile); Haumschild v. Continental Cas. Co., 7 Wis. 2d 130, 95 N.W.2d 814 (1959). See generally Ehrenzweig, *Parental Immunity in Conflict of Laws,* 23 U. CHI. L. REV. 474 (1956); Ford, *Interspousal Immunity for Automobile Accidents in Conflict of Laws: Law and Reason Versus the Restatement,* 15 U. PITT. L. REV. 397 (1954).

[19] Grant v. McAuliffe, 41 Cal. 2d 859, 866, 264 P.2d 944, 949 (1953) (survival of tort action is question of administration of decedent's estate governed by law of decedent's domicile).

[20] See, *e.g.,* Pacific Employers Ins. Co. v. Industrial Acc. Comm'n, 306 U.S. 493 (1939); Alaska Packer Ass'n v. Industrial Acc. Comm., 294 U.S. 532 (1935).

[21] Haumschild v. Continental Cas. Co., 7 Wis. 2d 103, 137, 95 N.W.2d 814, 818 (1959).

[22] See Schmidt v. Driscoll Hotel, Inc., 249 Minn. 376, 82 N.W.2d 365 (1957) (forum's dram shop act applied to hold innkeeper liable for negligent act occurring outside forum).

[23] Commenting on his opinion in Grant v. McAuliffe, 41 Cal. 2d 859, 264 P.2d 944 (1953), Judge Traynor says:

> It may not be amiss to add that although the opinion in the case is my own, I do not regard it as ideally articulated, developed as it had to be against the brooding background of a petrified forest. Yet I would make no more apology for it than that in reaching a rational result it was less deft than it might have been to quit itself of the familiar speech of choice of law.

Traynor, *Is This Conflict Really Necessary?,* 37 TEXAS L. REV. 657, 670 n.35 (1959).

*ment's* mechanical rules[24] and the adoption of other approaches, some emphasizing an analysis of the policies and interests of the competing states,[25] some the interests of the parties involved,[26] and others the significant contacts of the states with the tortious occurrence and the parties[27] to determine which jurisdiction's law applies. The latter approach has been adopted by the second *Restatement* in place of the *lex loci delicti* rule.[28] However, it was not until

[24] Cheatham & Reese, *Choice of the Applicable Law*, 52 COLUM. L. REV. 959 (1952); Currie, *Conflict, Crisis and Confusion in New York*, 1963 DUKE L.J. 1; Currie, *The Disinterested Third State*, 28 LAW & CONTEMP. PROB. 754 (1963); Ehrenzweig, *The "Most Significant Relationship" in the Conflicts Law of Torts*, 28 LAW & CONTEMP. PROB. 700 (1963); Ehrenzweig, *Comments on Babcock v. Jackson*, 63 COLUM. L. REV. 1243 (1963); Harper, *Policy Bases of the Conflict of Laws: Reflections on Rereading Professor Lorenzen's Essays*, 56 YALE L.J. 1155 (1947); Morris, *The Proper Law of a Tort*, 64 HARV. L. REV. 881 (1951); Reese, *Conflict of Laws and the Restatement Second*, 28 LAW & CONTEMP. PROB. 679 (1963); Stumberg, *"The Place of the Wrong": Torts and the Conflict of Laws*, 34 WASH. L. REV. 388 (1959); Traynor, *supra* note 23.

[25] Most critics agree that any approach to the solution of a conflicts problem must include an analysis of the policies of the competing states, but there is a divergence of views as to the methods to be used in analyzing the policy interests in order to determine which state's law should be applied. Some critics prefer to analyze the policy interests underlying the respective laws in terms of each state's contact with the events and parties, weighing the respective policies in light of their contacts. See Cheatham, *Comments on Babcock v. Jackson*, 63 COLUM. L. REV. 1229 (1963); Lefar, *Comments on Babcock v. Jackson*, 63 COLUM. L. REV. 1247 (1963); Weintraub, *A Method for Solving Conflict Problems—Torts*, 48 CORNELL L.Q. 215 (1963). On the other hand, Professor Currie prefers an analysis by the forum of its governmental interests in the issues. If the forum finds a legitimate interest, Currie believes the forum should apply its law even if the foreign state has a contrary interest. See Currie, *Comments on Babcock v. Jackson*, 63 COLUM. L. REV. 1233 (1963); Currie, *Conflict, Crisis and Confusion in New York*, 1963 DUKE L.J. 1.

[26] Analysis of the interests of the parties in light of the forum's policy is the solution proposed by Professor Ehrenzweig. This approach emphasizes the interests of the defendant by applying the law of the forum if such application will not be prejudicial to the defendant. Ehrenzweig says the primary interests the forum should consider are the ability of the defendant to procure liability insurance adequate under the applicable law and the ability of the insurer to reasonably calculate the premium. Ehrenzweig, *Comments on Babcock v. Jackson*, *supra* note 24.

[27] This approach analyzes the competing state's contacts with the events and parties to determine which state has the most significant relationship to the events and parties and applies that state's law. See note 28 *infra*.

[28] RESTATEMENT (SECOND), CONFLICT OF LAWS § 379 (Tent. Draft No. 9, 1964, approved May 21, 1964):

> (1) 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.

1963 that a court overruled the place of wrong rule in a tort action. In this case, *Babcock v. Jackson*,[29] the New York Court of Appeals formulated a jurisdiction-selecting test in which the forum analyzes the policies of each state as expressed in their conflicting laws and weighs the interests of each in vindicating its policy in light of its physical contacts with the events and the parties. This test combined several of the approaches that have been urged by critics to replace the traditional rule.[30]

The Pennsylvania court in *Griffith* followed the test set forth in *Babcock*. In determining that Pennsylvania's damage law applied, the court first analyzed the interests of Colorado and the policies behind her damage law in light of her contacts with the events and parties. Colorado's lone contact with the occurrence was place of wrong. The court found that the state where the wrong occurs has no interest in compensation where, as here, death is immediate and the site of the accident is fortuitous. In considering the policy reasons behind the damage limitation, the court indicated Colorado's lack of interest in the amount of recovery in a Pennsylvania court,

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(2) Important contacts that the forum will consider in determining the state of most significant relationship include:

(a) the place where the injury occurred,

(b) the place where the conduct occurred,

(c) the domicil, nationality, place of incorporation and place of business of the parties, and

(d) the place where the relationship, if any, between the parties is centered.

(3) In determining the relative importance of the contracts, the forum will consider the issues, the character of the tort, and the relevant purposes of the tort rules of the interested states.

See Reese, *supra* note 24. For a criticism of the RESTATEMENT (SECOND) approach, see Comment, *The Second Conflicts Restatement of Torts: A Caveat*, 51 CALIF. L. REV. 762 (1963).

[29] 12 N.Y.2d 473, 191 N.E.2d 279, 240 N.Y.S.2d 743 (1963), 77 HARV. L. REV. 355 (1963); 42 N.C.L. REV. 419 (1964); 49 VA. L. REV. 1362 (1962). The court allowed a New York domiciliary who was injured in Ontario while riding as a guest passenger in a New York automobile to recover against the host driver who was also a New York domiciliary, although Ontario prohibits recovery by a guest against a host driver. See *Comments on Babcock v. Jackson, a Recent Development in Conflict of Laws*, 63 COLUM. L. REV. 1212 (1963). *But cf.* Sparks, *Babcock v. Jackson—A Practicing Attorney's Reflections upon the Opinion and Its Implications*, 31 INS. COUNSEL J. 428 (1964).

[30] See *Comments on Babcock v. Jackson, a Recent Development in Conflict of Laws, supra* note 29. Professor Currie, referring to the reasoning of the *Babcock* court, says: "Indeed, the majority opinion contains items of comfort for almost every critic of the traditional system." Currie, *Comments on Babcock v. Jackson*, 63 COLUM. L. REV. 1233, 1234 (1963).

because the policy behind the limitation could only be intended to prevent Colorado courts from engaging in "speculative computation of expected earnings"[31] or to prevent large verdicts against Colorado defendants. On the other hand, the court concluded that Pennsylvania had an interest in the amount of compensation. The relationship giving rise to the air line's duty to the decedent arose in Pennsylvania, and more important, the decedent and his surviving dependents were domiciled in that state. Because of these contacts, the court considered Pennsylvania to be vitally concerned with the administration of the decedent's estate and the well-being of the surviving dependents to the extent of granting full recovery, including expected earnings.[32] Finally, the court examined the interests of the defendant and concluded that subjecting the air line to unlimited recovery placed no undue burden on it or its insurer for both could protect against this eventuality.

The jurisdiction-selecting rule followed in *Griffith* is designed to choose the law of one state for each particular issue presented.[33] In *Griffith,* the issue was damages. Presumably, if asked to decide which state's standard of care should apply, the court would look to Colorado law because Colorado has a greater interest that Pennsylvania in requiring a given standard of care within its borders. In contrast to this approach, both the first and second *Restatement* rules choose the law of one state to govern all issues of the case.[34]

[31] Griffith v. United Air Lines, Inc., 203 A.2d 796, 807 (Pa. 1964).

[32] Pennsylvania's policy of granting full recovery is found in its constitution which prohibits the state legislature from limiting recovery for injuries resulting in death. PA. CONST. art. III, § 21. Conceivably, the court in *Griffith* could have refused to apply Colorado's damage limitation as being against the strong public policy of the forum and thus avoided overruling the place of wrong rule. See Mertz v. Mertz, 271 N.Y. 466, 472, 3 N.E.2d 597, 599 (1936) (public policy defined as "the law of the state, whether found in the Constitution, the statutes or judicial records"); Kilberg v. Northeast Airlines, Inc., 9 N.Y.2d 34, 40, 172 N.E.2d 526, 528, 211 N.Y.S.2d 133, 136 (1961) (damage limitation of place of wrong against forum's public policy of allowing full recovery, defined in the forum's constitution).

[33] See Babcock v. Jackson, 12 N.Y.2d 473, 191 N.E.2d 279, 240 N.Y.S.2d 743 (1963); Dym v. Gordon, 411 Misc. 2d 657, 245 N.Y.S.2d 656 (Sup. Ct. 1963).

[34] RESTATEMENT, CONFLICT OF LAWS § 384, (1934); RESTATEMENT (SECOND), CONFLICT OF LAWS § 379 (Tent. Draft No. 9, 1964, approved May 21, 1964). The introductory note to § 379 of the RESTAREMENT (SECOND) states that "the law selected governs all issues dealt with in Title B (§ 3791-390g)." For example, § 380 provides that "the law selected by application of the rule of § 379 determines the standard of care by which the actor's conduct shall be judged."

The latter approach arbitrarily ignores the often valid interests of another jurisdiction in one or more issues of the case.

The underlying concept of any test that rejects the traditional rules of conflicts seems to be that the forum will avoid, where possible, laws that deny or limit the injured party's recovery. The *Griffith* test places certain limitations on such a policy. The forum may apply the law of another jurisdiction if the forum determines that that jurisdiction has a greater policy reason than the forum in seeing its laws vindicated. Except where the defendant is domiciled in the state, it is questionable if the place of wrong ever has a policy interest in the determination of the amount of recovery, because its policies of limiting recovery have no relationship to the events and parties.[35] Where the defendant is domiciled in the place of wrong, it may have a policy interest in protecting its domiciliary from excessive tort liability.[36] On the other hand, the place of wrong always has a greater interest in requiring a given standard of conduct within its borders.[37] Another limitation on the policy of allowing full recovery is the protection of the defendant's personal interests. If the defendant cannot reasonably protect against the application of the liability of the forum, the forum may apply the law of the place of wrong. In the case of interstate enterprises in general and specifically in the case of air lines, this consideration is meaningless, for such concerns must protect against all forms of liability in all jurisdictions in which they do business.[38] Finally, the *Griffith* test may be used by courts to select the law of the place of wrong where obligations, such as medical

[35] Weintraub, *supra* note 25, at 220, 227. See 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); Haumschild v. Continental Cas. Co., 7 Wis. 2d 130, 95 N.W.2d 814 (1959).

[36] See Kilberg v. Northeast Airlines, Inc., 9 N.Y.2d 34, 172 N.E.2d 526, 211 N.Y.S.2d 133 (1961) (place of wrong said to have a policy interest in limiting liability of domiciled air line). See generally Currie, *Conflict, Crisis and Confusion in New York, supra* note 24. It is questionable whether the place of wrong has an interest in protecting its domiciled corporation when that state has no interest in protecting the defendant if the tort occurs in another jurisdiction. Weintraub, *supra* note 25, at 228-29.

[37] Babcock v. Jackson, 12 N.Y.2d 473, 483, 191 N.E.2d 279, 285, 240 N.Y.S.2d 743, 750-51 (1963). Referring to the issue of the defendant's standard of care, the court said: "[I]t is appropriate to look to the law of the place of the tort so as to give effect to that jurisdiction's interest in regulating conduct within its borders, and it would be almost unthinkable to seek the applicable rule in the law of some other place." *Ibid.*

[38] EHRENZWEIG, CONFLICT OF LAWS § 213 (1962).

expenses, are incurred in that jurisdiction, because that jurisdiction has an interest in seeing that the obligations are met. This interest seems relevant only where application of the forum's law would completely deny recovery, because where damage limitations are involved some recovery is always assured if a tort has been committed; hence such obligations will be met regardless of which state's law is applied.

The fact situation in *Griffith* posed an ideal situation for the application of the forum's law. By varying the facts to bring into play any of the limitations that may deny the use of the forum's law, there is created what has been called a true conflicts problem because each state has a valid interest in seeing its laws applied.[39] Under the *Griffith* rationale, if the forum is the domicile of the injured party, the conflict will usually be resolved in favor of the forum, for in balancing the interests and policies in light of the contacts, the forum will give greater weight to its interests and policies than those of another jurisdiction.[40] But if a disinterested forum were to apply the same test, the balancing of the interests and policies would be made without the emphasis on the law of the domicile of the injured parties, and a different conclusion could be reached.[41]

By subjecting the law of conflicts to a test that balances the interests and policies of the states involved in order to yield a socially desirable result, the Pennsylvania court may have opened a

[39] See Currie, *The Disinterested Third State, supra* note 24, at 764. Currie considers Kilberg v. Northeast Airlines, Inc., 9 N.Y.2d 34, 172 N.E.2d 526, 211 N.Y.S.2d 133 (1961), to be an example of a true conflict problem because the forum has an interest in protecting its domiciled plaintiff by granting full recovery and because the place of wrong has an interest in protecting its domiciled corporation, which is also doing business in the state, from unlimited liability. In *Kilberg,* a New York domiciliary was allowed full recovery under New York law as a matter of public policy in a wrongful death action arising out of a plane crash in Massachusetts. The defendant air line was domiciled in Massachusetts, which limited recovery in wrongful death actions.

[40] See Kilberg v. Northeast Airlines, Inc., *supra* note 39. In 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), the court held that the result reached in *Kilberg* did not violate the full faith and credit clause of the Constitution because "a state with substantial ties to a transaction in dispute has a legitimate constitutional interest in the application of its own rules of law." 309 F.2d at 559. *Cf.* Richards v. United States, 369 U.S. 1 (1962).

[41] See Skahill v. Capital Airlines, Inc., 234 F. Supp. 906 (S.D.N.Y. 1964); Gore v. Northeast Airlines, Inc., 222 F. Supp. 50 (S.D.N.Y. 1963).

Pandora's box of judicial uncertainty. With the introduction of such a rule, uniform treatment would not be given to a cause of action in all jurisdictions where it might be litigated.[42] Lack of uniformity between jurisdictions encourages forum-shopping to find the jurisdiction with the most advantageous law in which to bring the action.[43] Lack of predictability and certainty lengthens courtroom procedure through drawn-out adjudication of conflict problems.[44] Instability and confusion enters the field of conflicts under such a rule. On the other hand, the place of wrong rule totally ignores the policy considerations behind the laws of the other jurisdictions having contact with the occurrence. It ignores the interests of the parties by applying the law of a jurisdiction that does not purport to account for their interests. Furthermore, as the court in *Griffith* said, the standard it used is no less clear than the concepts of reasonableness and due process which the courts presently employ.[45]

In deciding to apply the law of the forum, the Pennsylvania court did not avoid the traditional rules by some devious characterization.[46] It chose to overrule the place of wrong rule in favor of a new test now followed by two jurisdictions.[47] The merits of such a test outweigh the place of wrong rule, which is still followed and reaffirmed by a majority of courts, including North Carolina.[48] The ideal conflict of laws rule is one that is uniform and predictable and yet produces just results. The traditional place of wrong rule is predictable and uniform, but its application often leads to unjust and arbitrary results. The *Griffith* test is designed to give socially desirable results. Although it is not uniform and certain at present, sophisticated judicial application of the *Griffith* test to numerous choice of law problems will hopefully produce sound precedents that establish its certainty and uniformity.

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[42] See Sparks, *supra* note 29, at 434-35.

[43] *Id.* at 435. *But see* Cravers, *The Changing Choice-of-Law Process and the Federal Court*, 28 LAW & CONTEMP. PROB. 373 (1963).

[44] *Cf.* Texas v. New Jersey, 85 Sup. Ct. 626 (1965).

[45] 203 A.2d at 806.

[46] For possible alternatives the *Griffith* court could have used to avoid overruling the place of wrong rule, see notes 15, 17 & 32 *supra*.

[47] Though other states have avoided the effects of the place of wrong rule, see notes 15-22 *supra*, only New York and Pennsylvania have overruled it.

[48] See, *e.g.*, Shaw v. Lee, 258 N.C. 609, 129 S.E.2d 288 (1963), where the court, when asked to overrule the place of wrong rule, replied, "We do not deem it wise to voyage into such an uncharted sea, leaving behind well established conflict of laws rules." *Id.* at 616, 129 S.E.2d at 293.

**Constitutional Law—Right to Counsel and Transcript on Appeal—Waiver—Retroactivity—Post-Conviction Hearing Act**

Following his conviction in 1959, the defendant gave notice of appeal in open court. Two months later the defendant again appeared in open court, and expressed a desire to withdraw his appeal. Although he had been represented by his own counsel at the trial, the defendant was indigent the second time he appeared in court, was without counsel, and had not been furnished a transcript of his trial even though he had asked the clerk of court for one. Four and one-half years later, the defendant filed a petition for a post-conviction hearing under the North Carolina Post-Conviction Hearing Act.[1] At the post-conviction hearing the defendant asserted a denial of his constitutional rights to have counsel on appeal and a transcript of his trial furnished by the state. The judge, however, ruled that the defendant had waived his right to a transcript by the withdrawal of his notice of appeal.[2] This ruling was reversed in 1964 by the North Carolina Supreme Court in *State v. Roux*.[3] Accordingly, the case was remanded to the superior court with an order that the defendant be permitted to appeal to the supreme court with appointed counsel.

Decisions of the United States Supreme Court dealing with the rights of an indigent appealing his conviction would seem to require such a holding. The principles set forth by these decisions also indicate that the North Carolina Supreme Court was correct in first ruling on whether the defendant had been denied the right to counsel and a transcript before deciding whether there was a waiver of the right to appeal. In *Douglas v. California*,[4] the Supreme Court held that the equal protection clause requires that an indigent have the benefit of counsel when the merits of his one and only appeal as of right are decided. *Douglas* applies to appeals from criminal convictions in the superior courts of North Carolina, because a defendant has as a matter of right only an appeal to the

[1] N.C. GEN. STAT. §§ 15-217 to -222 (1953, Supp. 1963). See generally 29 N.C.L. REV. 390 (1951).

[2] Although the defendant asserted a denial of counsel, the judge apparently did not rule on this question.

[3] 263 N.C. 149, 139 S.E.2d 189 (1964).

[4] 372 U.S. 353, 357 (1963).

supreme court.[5] Therefore, the court in *Roux* correctly held that the defendant as an indigent had a constitutional right to have counsel appointed to represent him on appeal.

The court in *Roux* held that under *Griffin v. Illinois*[6] the defendant had a constitutional right to a free transcript of his trial. However, in *Draper v. Washington*[7] the Supreme Court established that an indigent defendant's right to a transcript is not absolute, but depends upon the circumstances of the particular case.[8] Where the indigent needs a transcript of his trial in order to prepare an adequate record for appeal, the state must provide him with "means of presenting his contentions to the appellate court which are as good as those available to a nonindigent defendant . . . ."[9] Assuming that the defendant in *Roux* needed a transcript of his trial in order to prepare a record for appeal, the court was correct in holding that he had a constitutional right to a free transcript.[10]

The court in *Roux* was then faced with the question of whether the purported waiver of appeal by the defendant constituted a waiver of the constitutional rights to counsel and transcript. The court ruled that the defendant's withdrawal of his notice of appeal did not constitute a waiver of his rights of counsel and transcript.[11] The Supreme Court has recognized that constitutional rights may be waived by an individual,[12] but has made it clear that the waiver

[5] N.C. GEN. STAT. § 15-180 (1953) provides: "In all cases of conviction in the superior court for any criminal offense, the defendant shall have the right to appeal, on giving adequate security to abide the sentence, judgment or decree of the Supreme Court; and the appeal shall be perfected and the case for the Supreme Court settled, as provided in civil actions."

[6] 351 U.S. 12 (1956).

[7] 372 U.S. 487 (1963).

[8] Moreover, part or all of the stenographic transcript in certain cases will not be germane to consideration of the appeal, and a State will not be required to expend its funds unnecessarily in such circumstances. If, for instance, the points urged relate only to the validity of the statute or the sufficiency of the indictment upon which conviction was predicated, the transcript is irrelevant and need not be provided.
*Id.* at 495-96.

[9] *Id.* at 496.

[10] See also N.C. GEN. STAT. § 15-4.1 (Supp. 1963), which provides: "When an appeal is taken under this section the county shall make available trial transcript and records required for an adequate and effective appellate review."

[11] 263 N.C. at 157-58, 139 S.E.2d at 195.

[12] See, *e.g.*, Carnley v. Cochran, 369 U.S. 506 (1962); Moore v. Michigan, 355 U.S. 155 (1957); Adams v. United States *ex rel.* McCann, 317 U.S. 269 (1942); Johnson v. Zerbst, 304 U.S. 458 (1938); Patton v. United States, 281 U.S. 276 (1930).

of constitutional rights will not be lightly inferred[13] and that the Court will indulge every reasonable presumption against the waiver of fundamental constitutional rights.[14] In *Carnley v. Cochran*[15] the Court held that before there could be a waiver of the right to counsel in state criminal proceedings the state must have offered counsel to the indigent defendant. The Court said: "Presuming waiver from a silent record is impermissible. The record must show, or there must be an allegation and evidence which show, that an accused was offered counsel but intelligently and understandingly rejected the offer. Anything less is not waiver."[16]

Although *Carnley* involved the right to counsel at the trial level and was based on the due process clause[17] whereas *Douglas* involved the right to counsel on appeal and was based on the equal protection clause,[18] this distinction should make no difference in the application of the *Carnley* test of waiver to the right recognized in *Douglas*.[19] The defendant in *Roux* was not informed of his right to appointed counsel on appeal. Furthermore, his request for a transcript had been denied. Under the test of waiver formulated by *Carnley,* he did not waive his right to counsel and a transcript.

After holding that the defendant had not waived the right to counsel and a transcript, the court in *Roux* ruled that he had not waived his right to appeal when he had voluntarily and without duress withdrawn his prior notice of appeal. Although the court apparently based this holding on a finding that the defendant had not "intelligently and understandingly" waived the right to appeal,

[13] Smith v. United States, 337 U.S. 137 (1949).

[14] See Emspak v. United States, 349 U.S. 190 (1955); Smith v. United States, 337 U.S. 137 (1949); Glasser v. United States, 315 U.S. 60 (1942); Johnson v. Zerbst, 304 U.S. 458 (1938); Aetna Ins. Co. v. Kennedy, 301 U.S. 389 (1937); Hodges v. Easton, 106 U.S. 408 (1882).

[15] 369 U.S. 506 (1962).

[16] *Id.* at 516.

[17] *Id.* at 512-13.

[18] 372 U.S. at 358.

[19] In this tradition, our own constitutional guaranties of due process *and* equal protection *both* call for procedures in criminal trials which allow no invidious discriminations between persons and different groups of persons. *Both* equal protection *and* due process emphasize the central aim of our entire judicial system—all people charged with crime must, so far as the law is concerned, "stand on an equality before the bar of justice . . . ." Consequently at all stages of the proceedings the Due Process and Equal Protection Clauses protect persons like petitioners from invidious discriminations.

Griffin v. Illinois, 351 U.S. 12, 17, 18 (1956). (Emphasis added.)

the result should be the same regardless of the nature of the purported waiver of appeal—*i.e.*, without attempting to apply the *Carnley* test of waiver. Once a state grants the right to appeal a criminal conviction,[20] an indigent defendant is entitled under *Douglas* and *Griffin* to have this appeal decided with the aid of appointed counsel and a transcript furnished by the state.[21] A holding that an indigent defendant, uninformed of his rights under *Douglas* and *Griffin*, has waived the right to appeal is a denial of these rights, since the appeal is in effect being decided without the defendant having the benefit of counsel and a transcript. In short, where an appellate court finds that an indigent defendant was not offered counsel and a transcript following his conviction in the trial court, it apparently need not inquire further, since any adverse determination of the defendant's right to appeal would necessarily be an unconstitutional denial of the right to counsel on appeal and a transcript.

*Roux* also involved the retroactive application of *Douglas*, decided in 1963. In holding the defendant was entitled to counsel on appeal in 1959, *Roux* implicitly held *Douglas* to be retroactive. Retroactivity was not discussed in *Roux*, however; nor has it been in Supreme Court decisions applying *Douglas*. The result in *Roux* apparently follows the application that the Supreme Court has given to *Douglas*. In three instances[22] the Supreme Court has vacated the judgment of a state court where the indigent defendant's appeal without counsel occurred prior to the time of the decision in *Douglas*. In each of these cases, however, the defendant's appeal was decided in the state court during the interval between the state court's decision on the appeals of the petitioners in *Douglas* and the decision of the Supreme Court in *Douglas*. Because the decision

[20] The Supreme Court has recognized that the right to appeal is not a constitutional right and that the right depends on the state's having provided for appellate review. See *id.* at 18; Reetz v. Michigan, 188 U.S. 505, 508 (1903); McKane v. Durston, 153 U.S. 684, 687 (1894).

[21] The holding in *Douglas* is expressly limited to apply only to the first appeal which is granted as a matter of right from a criminal conviction. The Court stated that it was not dealing with a denial of counsel for the preparation of a petition for discretionary or mandatory review beyond the initial appeal granted as a matter of right. 372 U.S. at 356. In a state having two levels of appellate review, the above statement in the text should be limited to this extent.

[22] Daegele v. Kansas, 375 U.S. 1 (1963) (memorandum decision); Ausbie v. California, 375 U.S. 24 (1963) (memorandum decision); Tabb v. California, 375 U.S. 27 (1963) (memorandum decision).

in *Douglas* would have to apply back to the time the right was denied the petitioners in *Douglas* in order to assure equal protection of the law,[23] these cases cannot be considered conclusive as to the retroactivity of *Douglas*. In *Smith v. Crouse*,[24] however, the indigent defendant's petition for appointment of counsel for appeal had been denied some four months before the petitioners in *Douglas* had appealed to the state court without counsel. In a memorandum opinion,[25] the Supreme Court cited *Douglas* and reversed the state supreme court's ruling[26] that *Douglas* was not retroactive; the effect appears to be a retroactive application of *Douglas*. In all four of these cases the Court declined to write an opinion;[27] thus the full import of the decisions is not clear.[28]

Unquestionably, many inmates of North Carolina prisons were indigent at the time of their trial and were not offered counsel for appeal following their convictions. Under the retroactive application given *Douglas* in *Roux*, these individuals have been denied a constitutional right, *i.e.*, the right to counsel on appeal.

A simple and effective means of asserting the denial of this right is found in the North Carolina Post-Conviction Hearing Act,[29] as applied in *Roux*. General Statutes section 15-217 provides that no action shall be commenced under the act more than five years after the judgment resulting from an allegedly unconstitutional conviction unless the petitioner shows the delay was not caused by laches or negligence on his part.[30] One who was denied counsel

[23] See United States *ex rel.* Durocher v. La Vallee, 330 F.2d 303, 310 n.4 (1964).

[24] 378 U.S. 584 (1964) (memorandum decision).

[25] *Ibid.*

[26] Smith v. Crouse, 192 Kan. 171, 386 P.2d 295 (1963).

[27] The Supreme Court has treated cases involving lack of counsel at the trial level arising after the decision in Gideon v. Wainwright, 372 U.S. 335 (1963), in the same manner. In Pickelsimer v. Wainwright, 375 U.S. 2 (1964), the Court vacated and remanded ten pre-*Gideon* convictions back to the state court "for further consideration in light of *Gideon v. Wainwright*."

[28] In this respect a statement from Mr. Justice Harlan's dissenting opinion in Pickelsimer v. Wainwright, 375 U.S. 2 (1964), seems appropriate: "In the current swift pace of constitutional change, the time has come for the Court to deal definitively with this important and far reaching subject [*i.e.*, retroactivity of decisions]."

[29] N.C. GEN. STAT. §§ 15-217 to -222 (1953, Supp. 1963).

[30] N.C. GEN. STAT. § 15-217 (Supp. 1963). It has been held that a state may attach reasonable time limitations on the assertion of constitutional rights under a post-conviction hearing act and that a provision similar to § 15-217 is constitutional. United States *ex rel.* Dopkowski v. Randolph, 262

in proceedings occurring more than five years before the decision in *Douglas* in 1963 should not be barred by section 15-217, since one could hardly be considered negligent in failing to assert the denial of a right that neither he nor anyone else knew existed prior to 1963. If a time limitation must be placed on the use of the act in this situation, it is suggested that the limitation should run from the time of the *Douglas* decision in 1963 and should certainly be no shorter than the five-year period of section 15-217. Defendants who were denied counsel on appeal less than five years before 1963 raise a different question, namely whether they should have the suggested five-year period beginning in 1963 or only such part of the statutory five-year period as remains after 1963. Although there is some authority indicating that the defendant would have only that part of the five-year period remaining in 1963,[31] it would be more in keeping with the purpose of the act to allow such a defendant the full five-year period beginning in 1963.[32] Of course, defendants who were denied counsel subsequent to 1963 call for an ordinary application of the act and thus pose no problem.

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F.2d 10 (7th Cir.), *cert. denied,* 359 U.S. 1004 (1959). Although such provisions have in some instances been given a strict interpretation, see, *e.g.,* United States *ex rel.* Lilyroth v. Ragen, 222 F.2d 654 (7th Cir.), *cert. denied,* 350 U.S. 939 (1956), the post-conviction hearing acts should not be construed so strictly that their purpose is defeated. See People v. Reeves, 412 Ill. 555, 107 N.E.2d 681 (1952). Accordingly, it has been held that a defendant is not barred by such a time limitation if he is feeble minded, Jablonski v. People, 330 Ill. App. 422, 71 N.E.2d 361 (1947), or if the asserted grounds for relief were fraudulently concealed from him. See Merkie v. People, 15 Ill. 2d 539, 155 N.E.2d 581, *cert. denied,* 359 U.S. 1015 (1959). However, a defendant's incarceration will not alone be sufficient to prevent the running of the limitation. See United States *ex rel.* Lilyroth v. Ragen, *supra;* People v. Austin, 329 Ill. App. 276, 67 N.E.2d 883 (1946).

[31] See United States *ex rel.* Lilyroth v. Ragen, *supra* note 30, where the defendant was in Indiana in prison when the Illinois Post-Conviction Hearing Act was enacted. He was returned to Illinois and imprisoned for a parole violation when only two months of the five-year limitation remained. It was held that he was barred by the time limitation because he did not file the petition for review under the Post-Conviction Hearing Act within the two-month period.

[32] See State v. Cruse, 238 N.C. 53, 76 S.E.2d 320 (1953) (purpose of the act is to provide an "adequate, simple and effective" post-conviction remedy); State v. Miller, 237 N.C. 29, 74 S.E.2d 513 (1953) (purpose of the act is to provide an "adequate and available" post-conviction remedy).

**Credit Transactions—Mortgages—Purchase by Life Tenant**

In *Morehead v. Harris*,[1] a husband, joined by his wife, had executed a deed of trust on two tracts of land as security for a loan. The husband died intestate with the debt outstanding. At a foreclosure sale pursuant to the terms of the deed of trust, the wife purchased the property for an amount equal to the unpaid balance of the loan plus the cost of foreclosure. She received a deed from the trustee purporting to vest in her a fee simple title to the property, which was worth considerably more than she had paid at the sale. The wife sold one tract of the property and devised the remaining tract to her sisters. Before her death, the children of her mortgagor-husband had begun litigation to recover both tracts of land. In granting a recovery to the children,[2] the North Carolina Supreme Court held that the wife purchased the property to protect her dower interest and, as a life tenant, she held the excess above her life estate in one-third of the property as trustee for the remaindermen.[3] By dictum, the court stated that if the wife, as life tenant, had paid more than her proportionate share, she would be a creditor of the estate for that amount.[4] The case gives rise to two issues that merit discussion: can a life tenant ever purchase mortgaged property free of trust and, when he cannot, how much of the purchase price can be recovered from the remaindermen as the excess above the life tenant's proportionate share?

[1] 262 N.C. 330, 137 S.E.2d 174 (1964). The case had come before the court once before, but was remanded to the superior court because of an omission of necessary parties. Morehead v. Harris, 255 N.C. 130, 120 S.E.2d 425 (1961).

[2] This statement should be qualified in that a recovery was granted to the children as opposed to the wife, but as to the tract conveyed by the wife, the court remanded for a new trial on the grounds that the purchasers of the property may be in the position of bona fide purchasers for value and that the children had done nothing to protect their title. 262 N.C. at 344, 137 S.E.2d at 187.

[3] The wife was also the administratrix of the husband's estate, and the court said that she was acting in a fiduciary capacity. It was stated that when the fiduciary purchased at his own sale, he was a "trustee for the benefit of the estate to prevent loss to the estate." *Id.* at 336, 137 S.E.2d at 180. Even though the wife did not purchase at her own sale (since this sale was conducted by the trustee and not the administratrix of the estate), the rule was said to apply. However, this reasoning is not important since the trust would have been implied even if the wife had not been the administratrix.

[4] *Id.* at 336, 137 S.E.2d at 181.

North Carolina seems to be within the majority rule[5] that the life tenant becomes a trustee for the remaindermen when he purchases directly at the foreclosure sale.[6] However, the court makes a distinction where the life tenant purchases from a third party who bought at the sale. In an earlier North Carolina case,[7] a wife had executed a deed of trust to secure a loan. After her death, her husband, a life tenant by curtesy, allowed a foreclosure.[8] The land was purchased by a stranger who, on the same day, transferred the title to the husband for a consideration equal to the purchase price. When the children of the wife sought to recover the property, the court held that no trust was implied absent a jury finding of fraud or that the stranger acted as agent for the husband. Therefore, the husband received a valid fee simple title to the property.

In considering the rationale and policy in the cases imposing a trust on the life tenant, there seems to be justification for different results when the life tenant purchases directly at foreclosure and when he purchases from a third person. It is clear that any person claiming an interest in the property under the intestate mortgagor may redeem the property until foreclosure, at which time the re-

[5] Bullock v. Peoples Bank, 351 Mo. 587, 602, 173 S.W.2d 753, 759 (1943); Tindall v. Peterson, 71 Neb. 160, 98 N.W. 688 (1904); MaGee v. Carter, 31 Tenn. App. 141, 148-49, 212 S.W.2d 902, 906 (1948). In *Tindall,* the wife of the mortgagor resigned as administratrix of his estate and purchased the property at the foreclosure sale. Without calling it a trust, the court held that she protected her life interest and the interest of the remaindermen.

[6] See Farabow v. Perry, 223 N.C. 21, 25 S.E.2d 173 (1943); Creech v. Wilder, 212 N.C. 162, 193 S.E. 281 (1937).

[7] Miller v. Marriner, 187 N.C. 449, 121 S.E. 770 (1924).

[8] Even though the life tenant holds the property as trustee for the remaindermen, there are times when the life tenant is justified in allowing a foreclosure on the deed of trust which will terminate the rights of the remaindermen in the property. It has been established in North Carolina that the life tenant is only liable to pay the interest on the encumbrance for the duration of the period in which the interest was due, and then only to the extent of the amount of "rent or actual value" received from the property. Therefore, the life tenant is not a trustee for the remaindermen in that he has to pay the interest to prevent a foreclosure under any circumstances. *Id.* at 455, 121 S.E.2d at 773. See also Williams v. Williams, 120 So. 2d 202 (Fla. 1960).

[9] In addition to the situation where the third party is acting as agent for the life tenant or there is fraud, it has been stated that the implied trust will also arise where there is an agreement between the life tenant and the third party that the life tenant provide an opportunity for the remaindermen to reimburse him and claim their interests. Clark v. Cantwell, 40 Tenn. 202 (1859).

demption rights are cut off.[10] It is also clear that the wife holds a dower right in the equity of redemption, the interest remaining in her mortgagor husband.[11] Since the wife is entitled to redeem the property before foreclosure, she is in an advantageous position to protect her dower interest from outside purchasers;[12] in saving such interest, she also protects the remaindermen from losing their rights in the property.[13] Therefore, if the wife does not redeem and is justified in allowing a foreclosure,[14] the courts will not allow her to bid in and purchase the property at a price below the fair value to the detriment of others claiming from the husband's estate.[15] In other words, she cannot obtain through a foreclosure purchase any estate in the property greater than she would obtain through redemption, and any attempt to do so will be barred by the court through imposition of a trust.

Aside from the fact that the life tenant will not usually be able to purchase at a price below the fair market value of the property when he buys from a third party who took under the foreclosure sale,[16] the main reason for allowing him to do so is that there is no detriment to the remaindermen. As previously stated, any person claiming under the intestate mortgagor has the power to redeem.[17] If the life tenant is justified in allowing a foreclosure, the rights of the remaindermen are cut off and there is no reason why the subsequent purchase by the former life tenant should be deemed to protect the interests of the remaindermen whose claims to the property are lost through their own inaction.

Assuming that the dowress does purchase at a foreclosure sale giving rise to an implied trust, or redeems the property in which case the mortgagee is entitled to the full amount of the encum-

[10] Brown v. Jennings, 188 N.C. 155, 124 S.E. 150 (1924); I SCRIBNER, DOWER 461 (1867).

[11] Gay v. J. Exum & Co., 234 N.C. 378, 67 S.E.2d 290 (1951), 30 N.C.L. REV. 310.

[12] The heirs could also redeem at any time before foreclosure if they were financially in a position to do so. See note 10 *supra* and accompanying text.

[13] Brown v. Jennings, 188 N.C. 155, 124 S.E. 150 (1924).

[14] See note 8 *supra* and accompanying text.

[15] For this basic proposition, see Tindall v. Peterson, 71 Neb. 160, 98 N.W. 688 (1904); Miller v. Marriner, 187 N.C. 449, 456, 121 S.E. 770, 774 (1924).

[16] Of course, the person bidding in at the foreclosure sale may not always be able to purchase the property for the amount of the encumbrance, but this was the case in both *Morehead* and Miller v. Marriner, *supra* note 15.

[17] See note 10 *supra* and accompanying text.

brance,[18] is she entitled to recover anything from the remaindermen for protecting their interests? North Carolina is in accord with the majority rule[19] that the wife is entitled to recover reimbursement from the remaindermen who wish to claim their interest in the property.[20] However, in using the language "if the life tenant pays more than his proportionate share, he simply becomes a creditor of the estate for that amount,"[21] the court in *Morehead* left two questions open: of whose estate is the life tenant a creditor and what is the "proportionate share" of the life tenant that must be determined to decide how much reimbursement he is entitled to?

In tracing the authority cited by the court, it is clear that the life tenant paying the encumbrance redeems from the mortgagee an interest in excess of the life estate and is subrogated to the rights of the mortgagee against this interest.[22] Moreover, the life tenant, having paid an obligation of the mortgagor, is entitled to a claim against his estate for the proportion of the amount paid by him for the interest beyond the life estate.[23]

As to a determination of the "proportionate share" of the wife,

[18] McCabe v. Bellows and Another, 73 Mass. 148 (1856). However, there are certain situations in which the wife does not have to pay the full amount of the encumbrance in order to get her dower allotment in the property. If the holder of the mortgage does not wish to enforce payment of the principal, the wife may be allowed to continually contribute an amount to the mortgagee which is sufficient to pay one-third of the yearly interest on the amount due. Bell v. Mayor &c. of New York, 10 Paige 49 (N.Y. 1843). Where the heirs of the deceased mortgagor have redeemed, the widow must make contribution to them "in proportion to the value of her life estate in one-third of the property" in order to redeem such life estate. Swaine v. Perine, 5 Johns. Ch. R. 482 (N.Y. 1821).

[19] Murphy v. May, 243 Ala. 94, 8 So. 2d 442 (1942); *In re* Daily's Estate, 117 Mont. 194, 159 P.2d 327 (1945); 2 WASHBURN, REAL PROPERTY § 1142 (6th ed. 1902). However, it should be noted that the remaindermen may not be compelled to contribute because he may feel that it is in his best interest not to have the property redeemed. Of course, the remainderman cannot claim his interest free of the mortgage without contributing his proportionate interest. I SCRIBNER, DOWER 461 (1867).

[20] Farabow v. Perry, 223 N.C. 21, 25 S.E.2d 173 (1943); Creech v. Wilder, 212 N.C. 162, 193 S.E. 281 (1937).

[21] 262 N.C. at 336, 137 S.E.2d at 181.

[22] Whitney v. Salter, 36 Minn. 103, 30 N.W. 755 (1886); Keller v. Fenske, 123 Wis. 435, 101 N.W. 378 (1904). It has also been held that the wife of the mortgagor husband can redeem the property before the death of the mortgagor husband since she has an interest, although inchoate, in the equity of redemption and can recover reimbursement from the estate because her position is analogous to that of a surety for her husband. Fitcher v. Griffiths, 216 MASS. 174, 103 N.E. 471 (1913).

[23] Whitney v. Salter, *supra* note 22; Keller v. Fenske, *supra* note 22.

however, the authority does not lead to a specific conclusion and the North Carolina court has never decided the question. A review of the case law from other jurisdictions reveals two different views in determining the amount of reimbursement which the life tenant is entitled to recover from the remaindermen exercising their rights to the property. In an early Maine case,[24] the wife's allotted dower included an entire mortgaged tract giving her a life estate in the whole mortgaged premises instead of just one-third of it. The court stated that after payment of the encumbrance on the mortgaged tract by the wife she would hold for her life, and at her death, the remaindermen could claim their interests by paying the wife's estate the *full amount* paid by her in extinguishing the debt.[25] Such a result raises two interesting points: the wife is not entitled to any reimbursement during her life, and when reimbursement is made, the wife's estate is not held responsible for the value of the use of the land during her life since at the time of the reimbursement the remaindermen get the entire property. On the other hand, the New York court[26] discussed the more usual case in which the wife's dower was a life estate in one-third of the mortgaged premises. Having paid the full amount of the encumbrance on the entire property, it was decided that the wife was required to contribute the present value of an annuity attributable to her life estate in one-third of the property and could only recover the excess paid from the remaindermen. The annuity for which the wife was responsible was determined by multiplying one-third of the yearly interest on the sum unpaid at the death of the husband by the number of years in the wife's life expectancy.[27] In contrast to the Maine view, the New York view holds the wife, as between her and the remaindermen, responsible for her proportional part.

In referring to a "proportionate share" in *Morehead,* the court seems to indicate that proportionate contribution would be required from the life tenant, thus following the New York view; it is possible that the New York court's method of determining the proportion to be paid by the dowress and the remaindermen would also be followed. If no interest were due on the loan to the mortgagor,

[24] Wilkins v. French, 20 Me. 111 (1841).
[25] *Id.* at 119.
[26] House v. House, 10 Paige 158 (N.Y. 1843).
[27] *Id.* at 165. *Accord,* Tindall v. Peterson, 71 Neb. 160, 98 N.W. 688 (1904).

as appears to be the case in *Morehead,* there may be nothing upon which to base the wife's proportionate share under the annuity principle. However, under such circumstances, it seems that the wife's proportion of the mortgage obligation could be derived by using the proportion that the cost of an annuity,[28] equal to the value of the use of one-third of the property for the period of the wife's life expectancy, bears to the whole value of the property.

Even with the abolition of dower under the present intestate law,[29] it is still possible for the *Morehead* situation to arise. Under the election provision,[30] if the widow of an intestate chose to become a life tenant in one-third of the mortgagor-husband's estate, the same problem of proportionate payment would arise. Absent an election, when the husband dies intestate the widow now receives a portion of his property in full fee, her share depending on the number of children surviving him.[31] Of course, her portion of the property would be subject to the mortgage; in order to free the property from debt, she may still be required to pay the full amount of the encumbrance.[32] In doing so, the wife would also be paying the debt on the portion going to the other heirs of the intestate, and she would be able to hold the property as security until she was reimbursed.[33] If the other heirs decided to exercise their rights to their portion of the property, she would then be able to recover from them the amount of the debt attributable to such portion plus interest. There would be no problem of evaluating the proportion which should be paid by the holder of a life estate.

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[28] For a determination of one's life expectancy, see the mortuary table in N.C. GEN. STAT. § 8-46 (Supp. 1963). To calculate the present value of an annuity based on one's life expectancy under the mortuary table, see N.C. GEN. STAT. § 8-47 (Supp. 1963).

[29] N.C. GEN. STAT. § 29-4 (Supp. 1963).

[30] N.C. GEN. STAT. § 29-30 (Supp. 1963).

[31] N.C. GEN. STAT. § 29-14 (Supp. 1963).

[32] See note 17 *supra* and accompanying text.

[33] II JONES, MORTGAGES § 1364 (8th ed. 1928); 2 WASHBURN, REAL PROPERTY § 1142 (6th ed. 1902).

**Evidence—Admissibility in Civil Actions of Evidence Illegally Obtained by Private Persons**

Evidence illegally obtained by a trespass or a breaking and entering by private persons is freely admissible in civil actions. In *Sackler v. Sackler*[1] the New York Court of Appeals rejected the attempt of a lower court to abandon this universal rule.[2] A divorce granted to the husband on grounds of adultery was allowed to stand, though the evidence used, including photographs, was obtained by the husband and private detectives in a predawn forcible entry of the wife's separately maintained apartment.[3]

The courts have constantly sought effective means of protecting persons from illegal searches. In England in 1762-1763 messengers of King George III conducted an infamous series of searches, seeking evidence of seditious libel. General warrants issued as authority for the searches were declared illegal, and trespass actions instituted by the search victims resulted in substantial damage judgments against the messengers and against the Earl of Halifax who, as Secretary of State, issued the warrants.[4] These actions are early and prominent examples of the traditional means used in the courts' attempts to control illegal searches—damages from the searchers are relied upon to discourage such acts of trespass, however much success on the principle issue as a direct result of the illegal search may encourage them.

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[1] 15 N.Y.2d 40, 203 N.E.2d 481, 255 N.Y.S.2d 83 (1964), *affirming* 16 App. Div. 2d 423, 229 N.Y.S.2d 61, *reversing* 33 Misc. 2d 600, 224 N.Y.S.2d 790 (Sup. Ct. 1962).

[2] See 8 WIGMORE, EVIDENCE § 2183 (McNaughton rev. 1961) for the rationale of the non-exclusionary rule. *E.g.:*

> It does not, logically, follow, however that records, being obtained can not be used as instruments of evidence, for the mere fact of [illegally] obtaining them does not change that which is written in them. . . . Suppose the presence of a witness to have been procured by fraud or violence, while the party thus procuring the attendance of the witness would be liable to severe punishment, surely that could not be urged against the *competency* of the witness!

Stevison v. Earnest, 80 Ill. 513, 517-18 (1875). See also Commonwealth v. Dana, 43 Mass. (2 Met.) 329 (1841).

[3] 33 Misc. 2d at —, 224 N.Y.S.2d at 795.

[4] Money v. Leach, 3 Burr. 1742, 97 Eng. Rep. 1075 (K.B. 1765); Entick v. Carrington, 2 Wils. 275, 95 Eng. Rep. 807 (K.B. 1765); Wilkes v. Wood, 2 Wils. 203, 95 Eng. Rep. 766 (K.B. 1763). More detailed reports of these cases can be found at 19 Howell's St. Tr. 1001, 19 Howell's St. Tr. 1029, and 19 Howell's St. Tr. 1153, respectively.

A concept of exclusion was introduced into American law in 1886 when the United States Supreme Court handed down its decision in *Boyd v. United States*.[5] In that opinion Mr. Justice Bradley described Lord Camden's opinion in *Entick v. Carrington*[6] as "one of the landmarks of English liberty"[7] and an incentive to the adoption of the fourth amendment.[8] But in *Boyd* the Court found it necessary to rely upon the fifth amendment's protection against self-incrimination to declare erroneous and unconstitutional the introduction of evidence obtained by a process it deemed an illegal search.[9]

In *Weeks v. United States*,[10] twenty-eight years after *Boyd* and ten years after exclusion based solely on the fourth amendment had been considered but rejected in *Adams v. New York*,[11] the Court finally made it clear that the federal rule would be to exclude evidence in criminal cases when it had been seized in violation of the fourth amendment. While limiting the rule to unconstitutional searches made by officers of the federal government and its agencies,[12] Mr. Justice Day, speaking for a unanimous Court, reasoned:

> If letters and private documents can thus be seized and held and used in evidence against a citizen accused of an offense, the protection of the Fourth Amendment . . . is of no value, and, so far as those thus placed are concerned, might as well be stricken from the Constitution.[13]

But in *Burdeau v. McDowell*[14] the Court refused to invoke this protective rule when the unconstitutional searches or seizures

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[5] 116 U.S. 616 (1886).
[6] 2 Wils. 275, 95 Eng. Rep. 807 (K.B. 1765).
[7] 116 U.S. at 626.
[8] The amendment reads:

> The right of the people to be secure in their persons, houses, papers and effects, against unreasonable searches and seizures, shall not be violated, and no Warrants shall issue, but upon probable cause, supported by Oath or affirmation, and particularly describing the place to be searched, and the persons or things to be seized.

[9] Wigmore approves the decision as "correct on simple Fifth Amendment grounds" but asserts that it made "fallacious conclusions" as to the fourth amendment. 8 WIGMORE, *op. cit. supra* note 2, § 2184a at 32.
[10] 232 U.S. 383 (1914).
[11] 192 U.S. 585 (1904). See 232 U.S. at 396, where the *Weeks* Court attempts to distinguish the decision in this case.
[12] 232 U.S. at 398.
[13] *Id.* at 393.
[14] 256 U.S. 465 (1921).

were by private persons, even when federal officials proposed to use evidence thus obtained in criminal prosecutions.[15] Mr. Justice Day, speaking for the majority,[16] said of the fourth amendment:

> Its origin and history clearly show that it was intended to be a restraint on the activities of sovereign authority, and was not intended to be a limitation upon other than governmental agencies . . . .
>
> In the present case the record clearly shows that no official of the Federal Government had anything to do with the wrongful seizure . . . . We assume that the petitioner has an unquestionable right of redress against those who illegally and wrongfully took his private property under the circumstances herein disclosed, but with such remedies we are not now concerned.[17]

In *People v. Defore*,[18] a 1926 decision, Judge Cardozo, then on the New York Court of Appeals, had to consider whether, in the light of the federal exclusionary rule manifested in *Weeks*, the state of New York should adopt a like policy. Both New York and the Supreme Court had rejected such a policy in *Adams*. Cardozo found nothing in the controlling New York statute[19]

> whereby official trespasses and private are differentiated in respect of the legal consequences to follow them. . . . Evidence is not excluded because the private litigant who offers it has gathered it by lawless force. By the same token, the State, when prosecuting an offender against the peace and order of society, incurs no heavier liability.[20]

Cardozo found the federal exclusionary rule "either too strict or too lax. . . . We must go farther or not so far."[21] And he chose not to go so far because

> the Legislature, which created it [the statute], has acquiesced in the ruling of this court that the prohibition of the search did not anathematize the evidence yielded through the search. If we had misread the statute or misconceived the public policy, a few words of amendment would have quickly set us right.[22]

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[15] *Id.* at 470, 476.

[16] Mr. Justice Brandeis and Mr. Justice Holmes dissented. *Id.* at 476.

[17] *Id.* at 475.

[18] 242 N.Y. 13, 150 N.E. 585, *cert. denied*, 270 U.S. 657 (1926).

[19] N.Y. CIV. RIGHTS LAW § 8. In 1938 this became part of the New York state constitution. N.Y. CONST. art. 1, § 12. The law is identical in wording with the fourth amendment. See note 8 *supra*.

[20] 242 N.Y. at 21-22, 150 N.E. at 588.

[21] *Id.* at 22, 150 N.E. at 588.

[22] *Id.* at 23, 150 N.E. at 588.

The United States Supreme Court eventually concluded that searches and seizures by state officers might violate the fourteenth amendment when the fourth amendment standard of reasonableness was not met, but for a long period the Court, like Cardozo, refused to widen the consequences.[23]

Of course, *Mapp v. Ohio*[24] changed all this. After refusing to allow federal officers to continue to turn over illegally seized evidence to state officers for state court prosecutions,[25] and destroying the "silver platter" doctrine that permitted evidence of federal crime illegally obtained by state officers to be used in federal courts,[26] the Court in *Mapp* forced the states, including New York,[27] to go just so far as the federal rule. The Court declared that "time [had] . . . set its face against . . . the 'weighty testimony' "[28] of *Defore* and reasoned that a uniform, if still severely limited,[29] rule of exclusion was "not only the logical dictate of prior cases, but it also makes very good sense."[30]

[23] See Irvine v. California, 347 U.S. 128 (1954); Salsburg v. Maryland, 346 U.S. 545 (1954); Wolf v. Colorado, 338 U.S. 25 (1949).

[24] 367 U.S. 643 (1961).

[25] Rea v. United States, 350 U.S. 214 (1956).

[26] Elkins v. United States, 364 U.S. 206 (1960).

[27] People v. Loria, 10 N.Y.2d 368, 179 N.E.2d 478, 223 N.Y.S.2d 462 (1961).

[28] 367 U.S. at 653.

[29] As it now stands, the federal exclusionary rule in criminal cases: (a) applies to evidence obtained as an indirect result of the illegal search—to the "fruits of the poisonous tree," Silverthorne Lumber Co. v. United States, 251 U.S. 385 (1920), including verbal evidence obtained after an illegal entry, Wong Sun v. United States, 371 U.S. 471 (1963); (b) does not operate to quash indictments based on tainted evidence, Lawn v. United States, 355 U.S. 339 (1958); Costello v. United States, 350 U.S. 359 (1956); Holt v. United States, 218 U.S. 245 (1910); (c) probably need not be raised by pretrial motion for suppression where the prosecution's evidence discloses the illegality for the first time, Gouled v. United States, 255 U.S. 298 (1921); FED. R. CRIM. P. 41(e); (d) applies to suppress contraband, though not to compel its return, Henry v. United States, 361 U.S. 98 (1959); United States v. Jeffers, 342 U.S. 48 (1951); Trupiano v. United States, 334 U.S. 699 (1948); (e) does not apply to searches or seizures by private persons, Burdeau v. McDowell, 256 U.S. 465 (1921); (f) applies only to searches of " 'persons, houses, papers, and effects,' " Hester v. United States, 265 U.S. 57 (1924), but automobiles are within the rule, Carroll v. United States, 267 U.S. 132 (1925); (g) applies only to searches invading defendant's own privacy, McDonald v. United States, 335 U.S. 451 (1948); (h) may be invoked by a corporate defendant, Silverthorne Lumber Co. v. United States, *supra*; (i) applies only to evidence seized in violation of the fourth amendment standard, with rare exception, Miller v. United States, 357 U.S. 301 (1958) (violation of D.C. local statute).

[30] 367 U.S. at 657.

Against this progression on the criminal side, it is, at first, strange that until *Sackler* was decided by the trial court no reported American court, with one limited exception,[31] had extended any like protection on the civil side.[32] However, since it is apparently still the rule that evidence illegally seized by private persons is not to be excluded in state[33] or federal[34] criminal actions, it is perhaps not so surprising, at least to one trained in legal niceties. The trial court, in excluding the *Sackler* evidence, thought the non-applicability of the exclusionary rule to seizures by persons other than federal agents (state officers *or* private persons)[35] "appears to have been overruled by *Elkins v. United States.*"[36] In his dissent, Judge Van Voorhis of the Court of Appeals also thought the *Elkins*[37] rejection of the "silver platter" doctrine should apply when the platter is offered by a private individual as well.[38] But the Court of Appeals majority's insistence that *Burdeau's* "definitive holding that the Fourth Amendment has nothing to do with nongovernmental intrusions . . . has never been overruled in this respect,"[39] is probably more accurate. This had been the Appellate Division's conclusion in reversing the trial court.[40]

If this is so, the fourth amendment is a poor peg on which to hang a civil exclusionary rule. And, despite Judge Bergan's extra-

[31] Lebel v. Swincicki, 354 Mich. 427, 93 N.W.2d 281 (1958). This case would exclude evidence of alcohol in a blood sample taken from defendant by a nurse at the direction of a state police officer, a violation of security of the person, and its application is probably limited to such extreme facts. Compare Breithaupt v. Abram, 352 U.S. 432 (1957).

[32] See, *e.g.*, Hair v. McGuire, 188 Cal. App. 2d 348, 10 Cal. Rptr. 414 (Dist. Ct. App. 1961) (no violation of federal mail law in seizure of evidence); Walker v. Penner, 190 Ore. 542, 227 P.2d 316 (1951) (personal injury; error in excluding whiskey bottle illegally taken from defendant's car by plaintiff's husband); Hartman v. Hartman, 253 Wis. 389, 34 N.W.2d 137 (1948) (divorce for adultery; no illegal search, but dictum that illegal search would not prevent admission of evidence).

[33] See, *e.g.*, People v. Johnson, 153 Cal. App. 2d 870, 315 P.2d 468 (Dist. Ct. App. 1957).

[34] See Burdeau v. McDowell, 256 U.S. 465 (1921).

[35] *Ibid.*

[36] 33 Misc. 2d at —, 224 N.Y.S.2d at 793. See also Williams v. United States, 282 F.2d 940, 941 (6th Cir. 1960).

[37] Elkins v. United States, 364 U.S. 206 (1960).

[38] 15 N.Y.2d at —, 203 N.E.2d at 484, 255 N.Y.S.2d at 87.

[39] *Id.* at —, 203 N.E.2d at 483, 255 N.Y.S.2d at 85.

[40] 16 App. Div. at —, 229 N.Y.S.2d at 63. Justice Hopkins disagreed. *Id.* at —, 229 N.Y.S.2d at 67 (dissenting opinion).

polation from Cardozo in *Defore*,[41] similar state statutory or constitutional provisions[42] are probably no better.

In England, where the doctrine behind such provisions first developed, "the question [of exclusion] has apparently arisen very infrequently,"[43] on either the criminal or civil side. There has been little discussion of illegal governmental seizures since the oft-quoted *Entick v. Carrington*[44] opinion of Lord Camden in 1765, and exclusion of evidence so seized is apparently discretionary with the trial judge.[45] However, in one English civil case[46] an exclusionary policy was announced, the evidence being copies[47] of privileged communications between attorney and client obtained "by collusion"[48] between the defendant and the attorney's clerk. An injunction was allowed against production of the copies as evidence. Cozzens-Hardy, Master of the Rolls, saw "no ground whatever in principle why we should decline to give the plaintiff the protection which in my view is his right as between him and . . . [the defendant]."[49]

This is a somewhat backhanded statement of what perhaps is a better basis for an exclusionary rule in civil actions. Not the fourth amendment, but something akin to the equitable doctrine of clean hands[50] and the common law maxim: "No one can take advantage of his own wrong."[51] However strictly a court is

[41] 15 N.Y.S.2d at —, 203 N.E.2d at 485, 255 N.Y.S.2d at 88 (dissenting opinion). See text accompanying note 21 *supra*.

[42] *E.g.*, N.C. CONST. art. I, § 15, which provides:

> General warrants, whereby any officer or messenger may be commanded to search suspected places, without evidence of the act committed, or to seize any person or persons not named, whose offense is not particularly described and supported by evidence, are dangerous to liberty and ought not to be granted.

[43] Cowen, *The Admissibility of Evidence Procured Through Illegal Seizures in British Commonwealth Jurisdictions*, 5 VAND. L. REV. 523, 528 (1952).

[44] 2 Wils. 275, 95 Eng. Rep. 807 (K.B. 1765).

[45] 15 HALSBURY'S LAWS OF ENGLAND, *Evidence* § 487 (Simonds ed. 1956).

[46] Ashburton v. Pape, [1913] 2 Ch. 469.

[47] Nor, because of the privilege, could the originals be introduced. *Id.* at 473. They had to be returned to the attorney. *Id.* at 472. Compare LeLong v. Siebrecht, 196 App. Div. 74, 187 N.Y. Supp. 150 (1921). See generally 8 WIGMORE, *op. cit. supra* note 2, §§ 2325, 2326; N.Y. CPLR § 4503.

[48] [1913] 2 Ch. at 471.

[49] *Id.* at 473.

[50] See McCLINTOCK, EQUITY § 26 (2d ed. 1948).

[51] BLACKSTONE, COMMENTARIES 952 (Gavit ed. 1941).

engaged in the matter strictly before it, can it afford to ignore the type of conduct its blindness may encourage in private persons?[52] The traditional legal remedy of a trespass suit against the illegal searchers is almost certainly inadequate.[53]

Something of this argument is implicit in the trial court's decision in *Sackler*. There Judge Brenner pointed out that "the divorce laws of the State of New York, confined as they are to the single cause of adultery are outmoded and archaic. . . . Hence, they foster disrespect of the law which the courts are powerless to halt."[54] He also noted that direct evidence of adultery, as might be obtained in a raid, frequently staged, is unnecessary.[55] "The continued disclosure of evidence of adultery procured in violation of fundamental civil liberties thus works a double harm upon the integrity of the judicial process."[56]

Judge Bergan's dissent in the Court of Appeals echoes this point:

> It is not possible to draw a fully logical difference on the question of admissibility between evidence wrongfully obtained by a private citizen and evidence wrongfully obtained by public authority. Indeed, since the motivation of public authority is the common good of the community and the motivation of the pri-

[52] Plaintiff's conduct in *Sackler* was not the innocent procedural error so often made by police, unskilled in constitutional subtleties, but a deliberate, planned trespass. 33 Misc. 2d at —, 224 N.Y.S.2d at 794. Plaintiff was accompanied by private detectives who had equipped themselves in advance to take photographs of what they found. Suppose a raid had been conducted by the wife instead of by the husband, and she had been the plaintiff in a New York divorce action. Her conduct might have prevented her from obtaining alimony. See N.Y. DOM. REL. LAW § 236, making the award of alimony discretionary with the court. However, if the wife herself is guilty of adultery, the court *cannot* award her alimony, though her husband is guilty of the same conduct, and no matter who seeks the divorce.

[53] *Quaere,* if the wife-defendant in *Sackler* were to sue the husband-plaintiff for trespass, would her loss of alimony be an element of damages? Probably not; her recoverable damages may be purely nominal. *But see* Humble Oil & Ref. Co. v. Kishi, 276 S.W. 190 (Tex. Comm. App. 1925), *modifying* 261 S.W. 228 (Tex. Civ. App. 1924) (damages allowed for destruction of speculative value). Compare Martel v. Hall Oil Co., 36 Wyo. 166, 253 Pac. 862 (1927). See generally 11 CORNELL L. Q. 416 (1926); 48 HARV. L. REV. 485 (1935); 4 TEXAS L. REV. 215 (1926); 36 YALE L. J. 1167 (1927). For the difficulties that arise in suing the perpetrators of an unconstitutional search, see Bell v. Hood, 327 U.S. 678 (1946), *on remand,* 71 F. Supp. 813 (S.D. Cal. 1947).

[54] 33 Misc. 2d at —, 224 N.Y.S.2d at 796.

[55] *Id.* at —, 224 N.Y.S.2d at 795.

[56] *Id.* at —, 224 N.Y.S.2d at 796.

> vate citizen the advantage of his lawsuit, it might be supposed we would more readily suppress wrongfully taken evidence in the private suit than in the criminal action.[57]

In allowing the use of evidence obtained by illegal acts by private persons is a court not involved in *unconstitutional* state action as in *Shelley v. Kraemer?*[58] In *Shelley* it was held violative of the fourteenth amendment's equal protection clause for a court to enforce a privately-made restrictive covenant. Is not the *Sackler* court, in allowing the illegally seized evidence, giving validity to an act that would violate the fourteenth amendment's due process clause if performed by any other branch of government? One writer has distinguished the court's role in *Sackler* as merely passive,[59] noting also that the concept of *Shelley* has yet to be applied to any but racial segregation cases.[60]

As *Sackler* suggests, the present state of the law is "clear and plain,"[61] and the only hope for change is in state legislatures, despite the *Sackler* defendant's attempt to ride "the crest of [*Mapp* and subsequent] . . . holdings."[62] *Mapp,* of course, indicates the reluctance of many states to adopt an exclusionary rule on the criminal side. But in civil litigation the interest that would be harmed by an exclusionary rule, that of private litigants who have committed illegal acts themselves rather than that of the public as a whole, seems hardly as meritorious. Some moves have been made. For example, New York has by statute adopted an exclusionary rule as to wiretap evidence in civil actions,[63] while per-

[57] 15 N.Y.2d at —, 203 N.E.2d at 485, 255 N.Y.S.2d at 88. Judge Bergan also argues that the landmark New York decision (*Defore*) "makes [it] quite clear that there is no distinction under the New York Civil Rights Law . . . between a private and a public invasion of privacy." *Ibid.*

[58] 334 U.S. 1 (1948).

[59] 46 MINN. L. REV. 1119 (1962). "In *Shelley* the lower court was asked to compel a private citizen to do an act which would be unconstitutional for the state to perform, whereas in the instant case the court was merely asked to give evidentiary status to illegally seized information." *Id.* at 1124-25. As to passive state action, consider Charlotte Park & Recreation Comm'n v. Barringer, 242 N.C. 311, 88 S.E.2d 114 (1955), *cert. denied,* 350 U.S. 983 (1956).

[60] 46 MINN. L. REV. 1119, 1125 (1962).

[61] 15 N.Y.2d at —, 203 N.E.2d at 484, 255 N.Y.S.2d at 86.

[62] 33 Misc. 2d at —, 224 N.Y.S.2d at 791.

[63] N.Y. CPLR § 4506. In Silverman v. United States, 365 U.S. 505 (1961), the exclusionary rule was applied to electronic eavesdropping by federal officers.

mitting such evidence in criminal cases.[64] It hardly seems that courts are significantly hindered in their search for the truth by such rules. And, if exclusion is to continue to be the rule in criminal cases, there is little logic in not extending it to civil litigation as well.[65]

CHARLES B. ROBSON, JR.

**Guardian and Ward—Estate Planning—Gifts by Guardian from Estate of Incompetent Ward**

Petitioner in *In re Trusteeship of Kenan*,[1] as trustee of the person and estate of an incompetent ward, sought authority, pursuant to legislative enactments,[2] to make gifts from the ward's income;[3] to make gifts from the principal of the ward's estate;[4] and, with regard to an inter vivos trust created by the incompetent, to surrender a reserved right of revocation and to make charitable gifts of the income therefrom which had been reserved to the incompetent for her lifetime.[5] On the first appeal,[6] the lower court orders[7] granting the requested authority were reversed by the North Carolina Supreme Court on the ground that the lower court's finding that the incompetent, if competent and heeding sound advice, would make the gifts was not supported by the evidence. Petitioner, apparently having relied solely on the statutes in his initial pleadings, was given leave to obtain permission to amend his petitions to al-

[64] N.Y. CODE CRIM. PROC. § 813-a; N.Y. CONST. art. I, § 12. See People v. Dinan, 11 N.Y.2d 350, 183 N.E.2d 689, 229 N.Y.S.2d 406, *cert. denied*, 371 U.S. 877 (1962).

[65] With sponsorship of the Bar Association of the City of New York, a commission to review and make recommendations on all aspects of the antiquated New York divorce laws has been proposed to the 1965 New York Legislature. Editorial, N.Y. Times, Feb. 11, 1965, p. 38, col. 2. If such a commission is established, it would be well for it to consider as a part of its task the evidentiary implications of these laws as they are illustrated by the *Sackler* case.

[1] 261 N.C. 1, 134 S.E.2d 85 (1963); 262 N.C. 627, 138 S.E.2d 547 (1964).

[2] N.C. GEN. STAT. §§ 35-29.1 to -29.16 (Supp. 1963).

[3] See N.C. GEN. STAT. §§ 35-29.1 to -29.4 (Supp. 1963).

[4] See N.C. GEN. STAT. §§ 35-29.5 to -29.10 (Supp. 1963).

[5] See N.C. GEN. STAT. §§ 35-29.11 to -29.16 (Supp. 1963).

[6] *In re* Trusteeship of Kenan, 261 N.C. 1, 134 S.E.2d 85 (1963).

[7] Three separate proceedings took place in the superior court—one relating to gifts from income, another to gifts from principal, and the last to surrendering the right to revoke the trust and the lifetime income interest. Thus, three orders were issued below, and the proceedings were consolidated for purposes of appeal.

lege that the authority he sought was something which the incompetent would do, if competent, and to offer evidence to establish the truth of his allegations. On the second appeal,[8] a divided supreme court found the evidence adequate to support the lower court's findings of fact that the incompetent would have made the gifts and affirmed the judgments granting the trustee authority to make them on her behalf.

The *Kenan* litigation involves the rule that the estate of an incompetent may, with the approval of the court having jurisdiction,[9] be applied for the benefit of those whom the incompetent probably would have aided if of sound mind. The rule apparently finds its first expression in the old leading English case of *Ex parte Whitbread*.[10] There, a niece of the incompetent petitioned for an allowance from the surplus income of the incompetent's estate. In considering the petition, Lord Eldon set forth the following directive which subsequent cases have pursued: "[T]he Court, looking at what it is likely the Lunatic himself would do, if he were in a capacity to act, will make some provision out of the estate for . . . [the applicant]."[11]

This doctrine does not apply, however, to the most frequent class of applications—those by persons to whom the incompetent owes a legal duty of support.[12] Thus allowances have been made for husbands,[13] wives,[14] and minor children[15] of incompetents, not on the

[8] *In re* Trusteeship of Kenan, 262 N.C. 627, 138 S.E.2d 547 (1964).

[9] In North Carolina jurisdiction over the affairs of incompetents is vested in the clerks of superior courts. N.C. GEN. STAT. § 33-1 (Supp. 1963).

[10] 2 Mer. 99, 35 Eng. Rep. 878 (Ch. 1816). A reporter's note to *Ex parte* Whitbread refers to the earlier case of *In re* Cotton, but this case is apparently unreported. See Thompson & Hale, *The Surplus Income of a Lunatic*, 8 HARV. L. REV. 472, 474 (1895).

[11] 2 Mer. at 102, 35 Eng. Rep. at 879.

[12] The allowance to provide support for dependents of the incompetent person does not involve the so-called doctrine of substitution of judgment. That doctrine is called into being, in those jurisdictions wherein it is recognized, when the court is asked to make an allowance out of the incompetent's estate to persons for whom he is not bound to provide. *In re* Beilstein, 145 Ohio St. 397, 404, 62 N.E.2d 205, 208 (1945) (concurring opinion).

[13] *In re* DeNisson, 197 Wash. 265, 84 P.2d 1024 (1938) (husband indigent; family expenses chargeable against husband or wife); Edwards v. Abrey, 2 Phill. Ch. 37, 41 Eng. Rep. 855 (1846) (surplus after maintaining incompetent wife to be paid to husband).

[14] Booth v. Cottingham, 126 Ind. 431, 26 N.E. 84 (1891); Hallett v. Hallett, 8 Ind. App. 305, 34 N.E. 740 (1893); Tiffany v. Worthington, 96 Iowa 560, 65 N.W. 817 (1896); Thomasson v. Thomasson, 310 Ky. 234,

theory that the incompetent would have provided for them if sane, but because his disability does not alter the incompetent's legal duty to support his family, if able.[16] Where the applicant is an adult child, however, rather rigid adherence to requiring a finding that the incompetent himself would have made the gift has prevailed.[17] Exceptions to this requirement have been made where the adult child was incapacitated and unable to provide for himself.[18] In cases involving adopted children[19] and stepchildren[20] a finding that the incompetent would have made the gift has likewise been required, though courts have allowed grants for illegitimate children without specifying that the requirement be met.[21]

Allowances from the incompetent's estate have not been limited to members of his immediate family, however, and it is in making

219 S.W.2d 957 (1949); Pearl v. McDowell, 26 Ky. 658 (1830); *In re* Leech, 45 La. Ann. 194, 12 So. 126 (1893); *In re* Stewart, 22 Atl. 122 (N.J. Eq. 1891); *In re* Wilder, 174 Misc. 244, 20 N.Y.S.2d 69 (Sup. Ct. 1940); *In re* Taylor, 9 Paige 611 (N.Y. 1842); Snowdon v. Scranton-Lackawanna Trust Co., 46 Pa. D. & C. 418 (C.P. 1942) (wife's funeral expenses); *In re* Miegocki, 34 Luzerne Leg. Reg. Rep. 257 (Pa. C.P. 1940).

[15] Goskins v. Security-First Nat'l Bank, 30 Cal. App. 2d 409, 86 P.2d 681 (1939); Brackett v. Glaze, 72 Ga. App. 314, 33 S.E.2d 733 (1945); Hallett v. Hallett, *supra* note 14; *In re* Leech, *supra* note 14; Marsh v. Scott, 63 A.2d 275 (N.J. Super. 1949); *In re* Wilder, *supra* note 14; Cartwright v. Juvenile Court, 172 Tenn. 626, 113 S.W.2d 754 (1938); Foster v. Marchant, 1 Vern. 263, 23 Eng. Rep. 457 (Ch. 1684).

[16] Where the incompetent father's entire estate consisted of a railroad relief pension, all of which was required for the father's needs, the court exercised its discretion to deny an allowance for the support and education of the father's minor child. *In re* Henderson, 45 Pa. D. & C. 359 (C.P. 1942). See also Dutch v. Marvin, 72 Iowa 663, 34 N.W. 465 (1887); *In re* Bell, 56 N.Y.S.2d 257 (Sup. Ct. 1945); Sedar's Estate, 29 Pa. D. & C. 680 (C.P. 1937); *Ex parte* Weinrich, 20 Pa. Dist. 1070 (C.P. 1910).

[17] *In re* Schwartz, 27 Del. Ch. 223, 34 A.2d 275 (Ch. 1943); Citizens State Bank v. Shanklin, 174 Mo. App. 639, 161 S.W. 341 (1913); *In re* Beilstein, 145 Ohio St. 397, 62 N.E.2d 205 (1945); *In re* Hare, 26 Pa. D. & C. 553 (C.P. 1935); Farmer v. Farmer, 78 Tenn. 309 (1882) (requisite intent found).

[18] *In re* Hall, 19 Ill. App. 295 (1885); Sheneman v. Manring, 152 Kan. 780, 107 P.2d 741 (1940); Paglia's Estate, 25 Pa. D. & C. 316 (C.P. 1936) (burial expenses of tubercular daughter paid from incompetent mother's estate). It can be argued that this is not an exception to the rule at all, but rather that these are regarded as circumstances under which the incompetent would make the allowance.

[19] *In re* Heeney, 2 Barb. Ch. 326 (N.Y. 1847).

[20] *In re* Willoughby, 11 Paige 257 (N.Y. Ch. 1844).

[21] Halsey's Appeal, 120 Pa. 209, 13 Atl. 934 (1888); *Ex parte* Haycock, 5 Russ. Ch. 154, 38 Eng. Rep. 985 (1828). "What if this family was illegitimate? The children, at least, were those of Siegfried, and could not be turned out to starve just because they were bastards." Halsey's Appeal, *supra* at 214, 13 Atl. at 936.

grants to others that the *Whitbread* doctrine is most often applied.[22] Courts have made allowances to the incompetent's parents,[23] grandchildren,[24] brothers and sisters,[25] brothers and sisters of the half blood,[26] nieces and nephews,[27] and cousins.[28] While these rela-

[22] The difficulty I have had was as to the extent of relationship to which an allowance ought to be granted. I have found instances in which the Court has, in its allowances to the relations of the Lunatic, gone to a farther distance than grand-children—to brothers and other collateral kindred; and if we get to the principle, we find that it is not because the parties are next of kin of the Lunatic, or, as such, have any right to an allowance, but because the Court will not refuse to do, for the benefit of the Lunatic, that which it is probable the Lunatic himself would have done.

*Ex parte* Whitbread, 2 Mer. 99, 103, 35 Eng. Rep. 878, 879 (Ch. 1816). Where the *Whitbread* doctrine has been rejected, it has generally been on the ground that the state statute governing the powers of the court over the property of an incompetent was restrictive and did not permit a general application of the rule. See, *e.g.*, Kelly v. Scott, 215 Md. 530, 137 A.2d 704 (1957); Binney v. Rhode Island Hosp. Trust Co., 43 R.I. 222, 110 Atl. 615 (1920); Lewis v. Moody, 149 Tenn. 687, 261 S.W. 673 (1923).

[23] Gamble v. Leva, 212 Ala. 155, 102 So. 120 (1924); *Ex parte* Phillips, 130 Miss. 682, 94 So. 840 (1923); State *ex rel.* Kemp v. Arnold, 234 Mo. App. 154, 113 S.W.2d 143 (1938); O'Connor's Estate, 6 Pa. D. & C. 789 (C. P. 1925); *In re* Bala, 36 Luzerne Leg. Reg. Rep. 268 (Pa. C.P. 1941) (for mother's funeral); Seley v. Howell, 115 Tex. 583, 285 S.W. 815 (1926); *In re* Strozyk, 156 Wash. 233, 286 Pac. 646 (1930) (for expenses while visiting incompetent). Allowances for parents were denied in Lewis v. Moody, 149 Tenn. 687, 261 S.W. 673 (1923) (not within statute); *In re* Heck, 225 Wis. 636, 275 N.W. 520 (1937) (not within statute); and *In re* Booth, 22 L.T.R. 249 (Eq. 1854) (no allowance for past maintenance). One English case granted an allowance for a monument which the lunatic had contracted to have erected to his grandmother. *In re* Dyce Sombre, 10 L.T.R. 362 (Eq. 1848).

[24] *In re* Schley, 107 N.Y.S.2d 884 (Sup. Ct. 1951).

[25] Farwell v. Commissioner, 38 F.2d 791 (2d Cir. 1930); *In re* Buckley's Estate, 330 Mich. 102, 47 N.W.2d 33 (1951); *In re* Carson, 39 Misc. 2d 544, 241 N.Y.S.2d 288 (Sup. Ct. 1962); *In re* Battin, 171 Misc. 145, 11 N.Y.S.2d 891 (Sup. Ct. 1939); *In re* Calasantra, 154 Misc. 493, 278 N.Y. Supp. 263 (Chautauqua County Ct. 1935); *In re* Gilbert, 3 Abb. N. Cas. 222 (N.Y. 1876); *In re* Heeney, 2 Barb. Ch. 326 (N.Y. 1847). Allowances for brothers or sisters were denied in Stephens v. Marshall, 23 Hun 641 (N.Y. Sup. Ct. 1881); Monds v. Dugger, 144 S.W.2d 761 (Tenn. 1940); and *In re* Clark, 2 Phill. Ch. 292, 41 Eng. Rep. 951 (Ch. 1847).

> So, where a large property devolves upon an elder son, who is a Lunatic, as heir at law, and his brothers and sisters are slenderly or not at all provided for, the Court will make an allowance to the latter for the sake of the former; upon the principle that it would naturally be more agreeable to the lunatic, and more for his advantage, that they should receive an education and maintenance suitable to his condition, than that they should be sent into the world to disgrace him as beggars.

*Ex parte* Whitbread, 2 Mer. 99, 102, 35 Eng. Rep. 878, 879 (Ch. 1816).

[26] *In re* Farmers' Loan & Trust Co., 181 App. Div. 642, 168 N.Y. Supp. 952 (1918), *aff'd per curiam*, 225 N.Y. 666, 122 N.E. 880 (1919).

[27] *In re* Brice's Guardianship, 233 Iowa 183, 8 N.W.2d 576 (1943); *In re*

tives have been the most frequent beneficiaries, they have not been the only ones. Grants have been made to elderly persons whom the incompetent formerly had supported,[29] to a retired servant,[30] and to a former paramour.[31] And, though sometimes limited to those which the incompetent had been in the habit of making,[32] charitable gifts have also been allowed.[33]

While the general posture of the case law is undoubtedly to the effect that the court will do for the incompetent what it finds the incompetent himself would have done,[34] the rule probably should have been that the court will do what it would have been wise and prudent for the incompetent to have done.[35] At first blush the language of *Ex parte Whitbread* seems to indicate that the former is the rule, for the case says the court looks at "what it is likely the Lunatic himself would do, if he were in a capacity to act . . . ."[36] But closer scrutiny indicates otherwise, for it also

Ginsberg, 267 App. Div. 995, 48 N.Y.S.2d 240 (1944); *In re* Fleming, 173 Misc. 851, 19 N.Y.S.2d 234 (Sup. Ct. 1940); *In re* Farmers' Loan & Trust Co., *supra* note 26; Hambleton's Appeal, 102 Pa. 50 (1883); *In re* Creagh, 1 Drury & Wal. 323 (1888); *In re* Sparrow, L.R. 20 Ch. 320 (1882); *In re* Blair, 1 Myl. & C. 300, 40 Eng. Rep. 390 (Ch. 1836). An allowance was denied when the incompetent's nephew wanted it for the purpose of augmenting an idle and luxurious life. *In re* Kernochan, 84 Misc. 565, 146 N.Y. Supp. 1026 (Sup. Ct. 1914). See also *In re* Johnson, 111 N.J. Eq. 268, 162 Atl. 96 (1932); Lewis v. Moody, 149 Tenn. 687, 261 S.W. 673 (1923).

[28] *In re* Flagler, 248 N.Y. 415, 162 N.E. 471 (1928); *In re* Darling, 39 Ch. D. 208 (1888); *In re* Frost, L.R. 5 Ch. 699 (1870). Where the incompetent had not even known of the existence of a cousin in distressing circumstances, and no grounds existed for inferring an intention to aid him, the application was denied. *In re* Evans, 21 Ch. D. 297 (1882). See also Fixico v. Ming, 176 Okla. 358, 55 P.2d 1027 (1936).

[29] *In re* Heeney, 2 Barb. Ch. 326 (N.Y. 1847).

[30] *In re* the Earl of Carysfort, Craig & Ph. 76, 41 Eng. Rep. 418 (Ch. 1840).

[31] *In re* Parry, 7 L.T.R. 77 (Eq. 1846).

[32] *In re* Heeney, 2 Barb. Ch. 326 (N.Y. 1847).

[33] See *In re* Hall's Guardianship, 31 Cal. 2d 157, 187 P.2d 396 (1947); *In re* Brice's Guardianship, 233 Iowa 183, 8 N.W.2d 576 (1943); Citizens State Bank v. Shanklin, 174 Mo. App. 639, 161 S.W. 341 (1913); *In re* Heeney, *supra* note 32; *In re* Strickland, L.R. 6 Ch. 226 (1871).

[34] See, *e.g.*, *In re* Brice's Guardianship, *supra* note 33; Ford v. Security Nat'l Bank, 249 N.C. 141, 105 S.E.2d 421 (1958); *In re* the Earl of Carysfort, Craig & Ph. 76, 41 Eng. Rep. 418 (Ch. 1840). "The controlling principle is that the court will act with reference to the incompetent and for his benefit as he would probably have acted if sane." *In re* Brice's Guardianship, *supra* note 33 at 189, 8 N.W.2d at 580.

[35] See Thompson & Hale, *supra* note 10, at 473-74, 479-80; Note, 9 VILL. L. REV. 522 (1964).

[36] 2 Mer. at 102, 35 Eng. Rep. at 879.

says that "what . . . would be beneficial to . . . [the lunatic] should be done"[37] and that the court should apply the property as it thinks "it would have been wise and prudent in the Lunatic himself to apply it."[38] To allow the guardian to do for the lunatic what would be wise for the lunatic himself to do is certainly more consonant with the universal duty of the guardian to manage the ward's estate prudently.[39] Thus, it seems that in applying the *Whitbread* doctrine the courts often have imposed a burden upon the guardian which that opinion never envisaged[40] and one which may conflict with the normal obligations of guardianship.

Although the *Whitbread* doctrine was recognized in North Carolina in an early case,[41] the court there indicated a disinclination to follow it. A rule that the dependents of an incompetent would be provided for before creditors or others could share in his estate became well established in North Carolina,[42] but the court indicated that it would not extend the bounty to collateral relations and married children of the lunatic.[43] Statutes[44] passed in 1854, however, in effect provided for a limited application of the *Whitbread* doctrine by allowing advancements from surplus income to be made to designated relatives of the incompetent. In a recent case,[45] where the applicants were adult children of the incompetent whom the court could not have aided under the old North Carolina view,[46] the court expressed its interpretation of the statutes in language reminiscent of *Whitbread:* "If their father were mentally

[37] *Ibid.*

[38] *Id.* at 103, 35 Eng. Rep. at 879.

[39] See Fratcher, *Powers and Duties of Guardians of Property,* 45 IOWA L. REV. 264 (1960). "A guardian of property has power and, ordinarily, a duty to collect and take possession of the assets of his ward including land and personal property, manage them prudently, and protect them from deterioration or loss." *Id.* at 292, 294 (citing statutes and cases from numerous jurisdictions).

[40] For a more thorough critique, see Note, 9 VILL. L. REV. 522 (1964).

[41] Brooks v. Brooks, 25 N.C. 389 (1843).

[42] Read v. Turner, 200 N.C. 773, 158 S.E. 475 (1931); Lemley v. Ellis, 146 N.C. 221, 59 S.E. 683 (1907); *In re* Hybart, 119 N.C. 359, 25 S.E. 963 (1896); Adams v. Thomas, 81 N.C. 296 (1879); *In re* Latham, 39 N.C. 231 (1846).

[43] Brooks v. Brooks, 25 N.C. 389, 391 (1843).

[44] N.C. GEN. STAT. §§ 35-20 to -29 (1950).

[45] Ford v. Security Nat'l Bank, 249 N.C. 141, 105 S.E.2d 421 (1958).

[46] "[O]ur courts may not be authorized to extend the allowance . . . to advancements to married children, as is done in England." Brooks v. Brooks, 25 N.C. 389, 391 (1843).

competent, would he not aid them? If so, the court has the authority to use his money for that purpose."[47]

The *Kenan* litigation represents a response to further statutory developments in North Carolina, designed to authorize charitable gifts for estate planning purposes rather than to aid individual beneficiaries. Statutes passed by the 1963 General Assembly specifically authorized the guardian or trustee of an incompetent, under specified circumstances and with the approval of the resident judge of the superior court, to make gifts from income[48] or principal[49] for religious, charitable, educational, and other purposes, and to surrender the right to revoke a trust created by the incompetent and make a gift of the reserved life estate.[50] Although the statutes do not contain the old requirement that the court, before authorizing the gifts, must find that the incompetent, if sane, would have made them, on the first appeal of the instant case[51] the supreme court insisted that this requirement must be met.[52] The majority thought that to authorize the gifts merely because the guardian and the court believed they should be made, though it was not what the lunatic had done or would have done, would amount to a taking of property in derogation of the lunatic's constitutional rights.[53] A pungent dissent argued that the only taking was of the right of the trustee to do with the estate what the General Assembly had authorized him to do.[54]

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[47] Ford v. Security Nat'l Bank, 249 N.C. 141, 144, 105 S.E.2d 421, 424 (1958).

[48] N.C. GEN. STAT. §§ 35-29.1 to -29.4 (Supp. 1963).

[49] N.C. GEN. STAT. §§ 35-29.5 to -29.10 (Supp. 1963).

[50] N.C. GEN. STAT. §§ 35-29.11 to -29.16 (Supp. 1963).

[51] *In re* Trusteeship of Kenan, 261 N.C. 1, 134 S.E.2d 85 (1963).

[52] "A court may authorize a fiduciary to make a gift of a part of the estate of an incompetent only on a finding, on a preponderance of the evidence, at a hearing of which interested parties have notice, that the lunatic, if then of sound mind, would make the gift." *Id.* at 9, 134 S.E.2d at 91.

[53] *Id.* at 9, 134 S.E.2d at 91.

[54] The plantive language of Justice Higgins's closing paragraphs merits quotation:

> The trustee seeks to follow . . . sound business practices, but the Court says this is taking private property. To my single-track mind the only thing taken is the right of the trustee, acting for his beneficiary, to do with this vast estate what the General Assembly of North Carolina authorized him to do. The relatives in this public spirited family who are *sui juris* appear to have joined in the trustee's requests. The authority to follow the plan has been authorized by 170 of the people's representatives in session on Halifax street. It is now set aside by a majority of the seven on Morgan.
>
> This decision will haunt us. I vote to affirm.

*Id.* at 17, 134 S.E.2d at 97.

Because the court required a finding as to what the incompetent would have done, the entire thrust of the case on remand[55] was toward establishing that the incompetent, if competent, would have made the gifts. Confronted with persuasive evidence presented in the trial court on both sides, the supreme court again divided. A majority found sufficient basis upon which to affirm the order granting the petition in a showing that: (1) it was wise and prudent to make the gifts; (2) the action was consistent with the trustee's powers and duties under the North Carolina statutes; (3) the natural objects of the incompetent's bounty would recommend to her that she take the action; (4) her trustee would explain the facts to her, if she were competent, and recommend that she make the gifts; (5) others of her kin would so recommend; (6) several tax and estate planning experts would advise her to take the action; and (7) her brother, whose advice she had always taken on business matters, would have advised her to make the gifts, and he believed she would have followed his advice. Equally convincing, however, are the factors compelling the dissent, viz.: (1) the incompetent's charitable gifts for the eight years prior to declaration of incompetency had amounted to only 8,160 dollars annually; (2) the largest single donation the incompetent had ever made was 25,000 dollars, though she was often solicited for much larger contributions; (3) there was no evidence she had ever considered donating to several of the institutions to which gifts were now recommended; (4) the incompetent had provided for certain charities in her will, thus showing those causes to which she wished to contribute and the amounts; (5) her will provided that anyone contesting or trying to change its provisions in any way would forfeit his interest thereunder; and (6) the incompetent had taken no steps toward making large charitable gifts, although she was, in the dissenting judge's opinion, fully aware of the impact of taxes, and also aware that donations to charity would mean an actual outlay of only a small portion of the gifts.[56]

[55] See the report of the second appeal, *In re* Trusteeship of Kenan, 262 N.C. 627, 138 S.E.2d 547 (1964).

[56] The dissenting judge seems to base this statement on the notion that a "financial expert and long-time friend" had informed her regarding these matters. The testimony of this "expert" indicates otherwise. See Record, vol. 1, pp. 237-47, especially pp. 239-42, *In re* Trusteeship of Kenan, 262 N.C. 627, 138 S.E.2d 547 (1964). The following statement seems emphatically to discredit such a notion:

I did not advise Mrs. Kenan in matters relating to estate planning,

When the evidence in *Kenan* that the incompetent would have made the gifts is contrasted to that in *In re duPont,*[57] a recent case in point, its tenuousness is accentuated. In *duPont,* the proposed distributees were also the takers under the incompetent's will,[58] and the gifts thus would in no way alter the incompetent's testamentary scheme apart from acceleration.[59] The incompetent was a businessman of great experience and responsibility, was sophisticated in the ways of taxation, and had previously made large gifts to members of his family.[60] Even more important, the incompetent had stated by letter after executing his will his intention to dispose of his property by lifetime gifts so as to reduce his estate to a stated amount.[61] Other documents indicated his concern for the most advantageous distribution and his apparent knowledge of the tax considerations involved.[62] Thus, there were not only acts and circumstances meriting inference of an intent to make the gifts, but also the incompetent's written declaration of his express resolution so to do.[63]

Seldom indeed, however, will there be evidence so favorable as that in *duPont,* and to make allowances on evidence no greater than that in *Kenan* is not unprecedented. In *City Bank Farmers Trust Co. v. McGowan*[64] substantial gifts had been allowed to a daughter,

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nor did I advise her in matters relating to the disposition of her property by Will or by gift. Estate planning was not a part of my duties, and I have never held myself out to be an estate planner to Mrs. Kenan or to anyone else.

Record, vol. 1, p. 240.

[57] 194 A.2d 309 (Del. Ch. 1963); 52 CALIF. L. REV. 192 (1964); 24 MD. L. REV. 332 (1964); 62 MICH. L. REV. 1471 (1964); 112 U. PA. L. REV. 1083 (1964).

[58] 194 A.2d at 310.

[59] In *Kenan,* by contrast, the vast majority of the proffered distributees were completely omitted from the terms of the will.

[60] 194 A.2d at 311.

[61] *Ibid.*

[62] *Ibid.*

[63] The only unfavorable circumstance was that the incompetent never executed his proposed plan. The court thought it a reasonable inference, however, that he deferred the making of the gifts because of the DuPont-General Motors anti-trust action which was pending from 1949 to 1962. To have made the gifts might have been to lend support to the government's contention that the incompetent and others had pursued a course of conduct designed to keep control of the DuPont Company in the family. *Id.* at 312.

[64] 43 F. Supp. 790 (W.D.N.Y. 1942), *aff'd,* 142 F.2d 599 (2d Cir. 1944), *modified,* 323 U.S. 594 (1945). See also City Bank Farmers Trust Co. v. Hoey, 23 F. Supp. 831 (S.D.N.Y. 1938). The cited cases are tax cases arising from New York Supreme Court proceedings of January 14, 1927,

to grandchildren, and to collateral heirs of the incompetent. Aside from an annual pittance to one, the incompetent had never made nor indicated any intention to make sizable allowances for the benefit of the collateral relatives or the grandchildren.[65] While she had made annual allowances to her daughters, the gifts authorized by the court far exceeded any the incompetent had ever made.[66] No need sufficient to prompt an altered pattern of giving by the incompetent was shown on behalf of any of the applicants.[67] In short, so deficient were data indicating that the incompetent would have made the gifts, that Judge Learned Hand concluded that the incompetent would have so acted only with the prospect of imminent incompetency before her, for

> the judges had *no evidence whatever* from her past conduct for supposing that . . . she would have given away every year to her daughter, her grandchildren and her brother and sisters, more than $160,000 out of the $250,000 which remained to her after paying her taxes and expenses. The allowances she had theretofore made did not remotely approach such figures.[68]

In *Kenan,* as in the *duPont* and *City Bank Farmers Trust Co.* cases, the object of making the gifts was not to meet any needs of the applicants, but solely to effectuate a sound estate plan. Reduction of the incompetent's taxable estate and a concomitant increase in the amount available for the ultimate distributees was the common purpose. While the greatest savings ensue if the gifts escape the estate tax and are taxed solely under the usually lower rates of the gift tax,[69] substantial savings will nonetheless result even if the gifts should be held to have been made in contemplation of death[70] and their amount restored to the gross estate for estate tax purposes. In such a case the gift tax paid is available as a credit against the estate tax,[71] and more importantly, the amount of

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and June 3, 1932, involving gifts from the estate of an incompetent ward. The facts before the state court are adequately set forth in the reports of the tax cases, and the discussion here is based thereon.

[65] 43 F. Supp. at 794.

[66] *Ibid.*

[67] *Ibid.*

[68] City Bank Farmers Trust Co. v. McGowan, 142 F.2d 599, 601 (1944). (Emphasis added.)

[69] *Cf.* INT. REV. CODE OF 1954, §§ 2011, 2502.

[70] INT. REV. CODE OF 1954, § 2035.

[71] INT. REV. CODE OF 1954, § 2012.

the gift tax is not itself restored to the gross estate.[72] As a result, the making of the gifts would occasion a minimal savings of sixteen million dollars in *duPont*[73] and over four and one half million dollars in the proceeding regarding the trust in *Kenan*.[74]

While the holding on the second appeal in *Kenan* made possible execution of the proffered estate plan, the first appeal leaves the law of North Carolina in an untenable state. To persist in requiring a finding that the incompetent himself would have made the gifts is to deny that sound estate planning is in itself sufficient reason to authorize the guardian to act.[75] Such tenacity seems inconsistent with the original requirements of *Ex parte Whitbread*[76] and defies sound policy and reasoning. The guardian is charged with managing the assets of his ward prudently and protecting them from deterioration and loss.[77] By refusing to allow him to do for the ward what any reasonable man of property would do for himself, *i.e.*, plan his estate, the court frustrates the guardian's attempt to perform this duty. Indeed, absent the finding that the ward would have so acted, it positively insures his failure.

Moreover, in many cases, if not most, it will be quite impossible for the court to divine just what the incompetent, when confronted with extant tax laws, would do. The question thus becomes largely one of policy, of deciding whether or not to do for the incompetent

[72] See Record, vol. 1, p. 317, *In re* Trusteeship of Kenan, 262 N.C. 627, 138 S.E.2d 547 (1964).

[73] 194 A.2d at 311.

[74] See Brief for Appellee, pp. 36-38, *In re* Trusteeship of Kenan, 262 N.C. 627, 138 S.E.2d 547 (1964); Record, vol. 2, pp. 314-17.

[75] A Pennsylvania court has held that tax avoidance is not a sufficient motive to justify distributing the incompetent's assets before his death. Bullock Estate, 10 Pa. D. & C.2d 682 (Orphans' Ct. 1957). But a New York court has held that to make distributions for the purpose of saving taxes and administration expenses is within the broad equity powers of the court. *In re* Carson, 241 N.Y.S.2d 288 (Sup. Ct. 1962).

> Such conclusion is fortified not alone by the savings which can be effected but by the further consideration that to do otherwise would result in a loss to the two principal objects of the decedent's bounty and a gain only to the executors in the form of increased commissions and the respective federal and state governments in the form of increased taxes.
>
> To do otherwise would lead to a result increasing estate costs to a point hardly consistent with our modern concept of estate planning for tax and other legitimate estate benefits.

*Id.* at 290.

[76] See text accompanying notes 34-40 *supra*.

[77] Fratcher, *Powers and Duties of Guardians of Property*, 45 IOWA L. REV. 264, 292-94 (1960). See also Note, 52 CALIF. L. REV. 192, 194 (1964).

that which the best interest of his estate dictates. In such circumstances no good reason exists for not resolving the inquiry in favor of a statutory interpretation allowing the soundest estate planning. Indeed, this is but to pursue the familiar legal standard of "the reasonably prudent man under the circumstances," and some courts have based distributions on this theory.[78] Supporting argument can be made that there is a pervasive tax avoidance motive in all persons of property[79] and that such may readily be imputed to the incompetent. Indeed, to presume otherwise is to impute a preference that one's property go to the government rather than to the natural or declared objects of his bounty—an unlikely predilection at best—and to effect a blatant discrimination against the heirs of incompetents. It thus seems the sounder policy to allow guardians wide discretion in planning their wards' estates, especially where, as in *Kenan,* there has been a finding that the ward will never recover competency.[80]

To allow such discretion within prescribed bounds seems precisely what the North Carolina legislature has attempted to do. The 1963 statutes[81] are so designed as to be applicable only to fortunes sufficiently substantial that estate planning is indispensable to their preservation. Moreover, the permission to make gifts is so circumscribed by conditions precedent that not only is harm to the estate highly unlikely, but benefit is virtually assured. Conjecture is inevitably involved in the common law approach of finding what the incompetent would have done under the circumstances. The statutory pattern, by contrast, posits an objective standard. When the prescribed conditions are met, legislative purpose as well as sound policy seems to demand a presumption that the incompetent would then have made the gifts. Precedent for such a construction may be found in the intestacy statutes,[82] which are presumed to reflect the wishes of a decedent who has left no will, no finding of actual intent being required. By reinvoking the requirement of finding what the

[78] *E.g.,* Potter v. Berry, 53 N.J. Eq. 151, 32 Atl. 259 (Ct. Err. & App. 1895); *In re* Bond, 198 Misc. 256, 98 N.Y.S.2d 81 (Sup. Ct. 1950); *In re* Fleming's Estate, 173 Misc. 851, 19 N.Y.S.2d 234 (Sup. Ct. 1940); Hambleton's Appeal, 102 Pa. 50 (1883); *Ex parte* Whitbread, 2 Mer. 99, 35 Eng. Rep. 878 (Ch. 1816).

[79] See Note, 52 CALIF. L. REV. 192, 196 (1964).

[80] *In re* Trusteeship of Kenan, 261 N.C. 1, 6-7, 134 S.E.2d 85, 89 (1963).

[81] N.C. GEN. STAT. §§ 35-29.1 to -29.16 (Supp. 1963).

[82] N.C. GEN. STAT. §§ 29-1 to -30 (Supp. 1961).

incompetent would have done, the court seems to have modified the legislative intent as well as to have rejected the sounder policy approach.

WILLIS PADGETT WHICHARD

**Practice and Procedure—Review of Order Remanding to State Court —Tactical Windfall Under the Civil Rights Act of 1964**

Title IX of the Civil Rights Act of 1964[1] institutes a procedure unique in present trial practice.[2] When a case, removed to the United States district court under section 1443 of title 28, is ordered remanded to the state court, that order may now be reviewed "by appeal or otherwise."[3] This amendment of the former rule exempting all orders to remand from review makes it possible for the defendant who alleges that a question of civil rights is involved to delay trial on the merits until the whole arsenal of federal review weapons has been exhausted. Extensive use of this delaying tactic may lead to a narrowing of the scope of review of these remand orders by legislative action or judicial interpretation.[4]

[1] 78 Stat. 266, 28 U.S.C.A. § 1447(d) (Supp. 1964).

[2] Unique as a practical matter; the United States may appeal from an order of remand in cases relating to lands of the five Civilized Tribes of Oklahoma. Act of Aug. 4, 1947, ch. 458, § 3(c), 61 Stat. 732. Professor Moore calls this a "minor statutory exception." 1A MOORE, FEDERAL PRACTICE ¶ 0.169 [2.-1], at 1452 (2d ed. 1961) [hereinafter cited as MOORE]. The description seems appropriate.

[3] Civil Rights Act of 1964 § 901, 78 Stat. 266, 28 U.S.C.A. § 1447(d) (Supp. 1964).

[4] Textual discussion here will be limited to the practical implications of section 901; no attempt will be made to justify or condemn it. Congressional debate on the merits of the amendment is summarized to exemplify the legislative intent behind the provision:

Experience over a period of eighty years has demonstrated the wisdom of making the decision of the judge of the U. S. District Court final in removal proceedings. This amendment would give to the civil rights litigant alone a right to appeal the remand order. This is an attempt to by-pass the state and district courts. The removal process is simple, and once the petition is filed the case is automatically removed. This deprives the state court of all powers of process and of the power to enter any order while the case is pending in the federal courts. [*But cf.* 28 U. S. C. § 1450 (1958).] Allowing appeal from removal orders upsets the delicate balance of power between the state and federal courts. 110 CONG. REC. 2769 (1964) (remarks of Representative Tuck).

The first removal statute in the field of civil rights was enacted shortly after the Civil War for the purpose of giving justice in civil rights cases.

Section 1443 of title 28 is the successor of that legislation and that section is not changed by the Civil Rights Act of 1964. Section 1447 is being amended and there is precedent for this change in that from 1875 to 1887 appeal was allowed in all cases ordered remanded to the state court. It is at least arguable that the 1887 law did not affect the right to appeal in civil rights cases. In any event, section 1443 has been narrowly applied. Removal is allowed under virtually one set of circumstances only, to wit, when a state law or state constitution on its face denies equal rights to a defendant. The Attorney General, in his testimony given when the bill was in committee, reported that without appeal section 1443 is useless. Proponents of the legislation are not asking for an extraordinary remedy. They are asking only that the useless law be reviewed, and that the appellate courts be able to re-interpret the extent of section 1443 so that, hopefully, it would be held to include state criminal prosecutions brought to intimidate the petitioner, cases involving community hostility making fair trial in state or local court unlikely or impossible, and other cases where circumstances make it likely or certain that a fair trial is precluded. This legislation does not upset the balance of judicial power and is not dilatory. *Id.* at 2770 (remarks of Representative Kastenmeier).

Initially all federal questions were decided in state courts. When removal to federal court was authorized by statute, no appeal was allowed because this was not considered a final judgment but rather an interlocutory decision. In 1885 [1875] legislation was enacted allowing appeals from all orders to remand. In 1887 the former practice was restored. This act would return the right to appeal in one class of cases only. What is the justification for such a procedure? The 1887 act denied appeal because the appeal procedure involves excessive delays. This is especially significant because the state court loses all jurisdiction while the case is being considered in the federal court. The *status quo* cannot be maintained. [*But see* 28 U.S.C. § 1450 (1958).] No process can issue. Subpoenas may expire. Witnesses may be lost. Substantive rights are still protected without legislation as proposed by Title IX. The federal appellate procedure protection from improper state court action is still available if constitutional rights need to be protected. *Id.* at 2771 (remarks of Representative Poff).

The proposed legislation is a direct slap at all district court judges. It will cause chaos in the administration of justice in state courts, for the process of state courts in civil rights cases will be paralyzed. "It would give so-called civil rights groups a special 'weapon' all their own, to use the terminology of Attorney William M. Kunster, counsel for CORE. It would effectively prevent for a long period of time any trial, Federal or State." Since 1887 the only procedure that has proved feasible is to make the decision of the district judge final. The devastating effect of the proposed legislation is apparent. Removal is automatic. The legal relief is an application for remand. The defendent already gets "two bites at the apple" in that the district court can keep the case by denying the application to remand, or, if the remand is ordered, an appeal in the federal courts is available after the case has been through the state courts. Further, injunction of an illegal act by the state court is nullified upon removal [*contra,* 28 U.S.C. § 1450 (1958)], and the question might be moot by the time of trial. In the criminal context, removal might come minutes before trial, and "trial could be put off almost indefinitely, especially considering the congested dockets of the federal courts of appeal." As to the charge that the present section is "useless," it is obvious that removal is useless where there is no federal jurisdiction. The inference of the Attorney General that judges of the federal district courts "have been less than honest in testing their own jurisdiction"

The first federal law allowing removal of a case from a state court on civil rights grounds was enacted in 1866 and provided that "citizens, of every race and color . . . shall have the same right . . . to full and equal benefit of all laws . . . as is enjoyed by white citizens."[5] The first case in which this statute was interpreted was decided by the Supreme Court of North Carolina, which held that an allegation of local community racial hostility entitled the defendant to remove.[6] The present statute, which dates from 1911,[7] provides that:

> Any of the following civil actions or criminal prosecutions, commenced in a State court may be removed by the defendant

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is a serious charge against the judges or an indication of lack of understanding of the purpose of removal. The Attorney General may not understand that the end does not justify the means. The wisdom of the end sought here is very debatable. Justice is delayed, and an appeal from a remand is not necessary to protect federal rights. *Id.* at 2771-73 (remarks of Representative Dowdy).

The reason for the special rule in civil rights is that there is a special problem which needs a solution. The proposed legislation provides a procedual remedy to handle the special problem. There has been difficulty especially in the voting cases. *Id.* at 2773 (remarks of Representative Lindsay).

The proposed legislation is the work of "bleeding hearts." It provides a special remedy for ten per cent of the population. *Id.* at 2780 (remarks of Representative Watson).

This amendment of section 1447(d) of title 28 was not a part of the original administration bill but rather was added by sub-committee. There is little about the provision in three volumes of testimony before the sub-committee. It is possible that this is an example of action without full realization. Dilatory practices are possible under this legislation, and it might be a bad precedent. *Id.* at 2782 (remarks of Representative Meader).

Litigants may be frustrated at the district court level in cases of harsh denial of constitutional rights if there is no right to appeal. "If the State prevails, the State has a right to appeal, but the plaintiff does not. [*sic*] . . . [T]itle IX . . . will get at those cases which are most tragic and where justice is in truth denied unless we can get the case to the appellate courts." *Id.* at 2784 (remarks of Representative Corman).

Civil rights cases might be exactly the kind that should be reviewed. The proposed legislation seeks to cure injustice. *Id.* at 2784 (remarks of Representative Edwards).

Essentially the same arguments were made when the Senate considered the bill sent up from the House. *Id.* at 6451 (remarks of Senator Dirksen), 6551 (Senator Humphrey), 6955 (Senator Dodd), 7784 (Senator Smathers), 11320 (Senator Sparkman), 11848 (Senator Humphrey), 13172 (Senator Byrd of W. Va.), 13468 (Senator Ervin), 13879 (Senator Byrd of W. Va.), 14459 (Senator Morton).

[5] Act of April 9, 1866, ch. 31, 14 Stat. 27.

[6] State v. Dunlap, 65 N.C. 491 (1871).

[7] Act of Mar. 3, 1911, ch. 231, § 31, 36 Stat. 1096.

to the district court of the United States for the district and division embracing the place wherein it is pending:

(1) Against any person who is denied or cannot enforce in the courts of such State a right under any law providing for the equal civil rights of citizens of the United States, or of all persons within the jurisdiction thereof;

(2) For any act under color of authority derived from any law providing for equal rights, or refusing to do any act on the ground that it would be inconsistent with such law.[8]

An order remanding a case to the state court was made reviewable "on writ of error or appeal" in 1875.[9] Twelve years later Congress stated categorically "that no appeal or writ of error from the decision . . . remanding . . . shall be allowed."[10] This practice, in substance, has been carried forward to the present time. When the revisers of the Judicial Code inadvertently overlooked the provision in the 1948 revision, an amendment was hastily enacted to clarify the intention that orders to remand would not be reviewed.[11] This legislation stated concisely that "an order remanding a case to the State court from which it was removed is not reviewable on appeal or otherwise."[12] The Civil Rights Act of 1964 adds the exception "that an order remanding a case to the State court from which it was removed pursuant to section 1443 of this title shall be reviewable by appeal or otherwise."[13]

The procedure to be followed to effect removal is uncomplicated and is set out in the statute.[14] All that is required is that the defendant file a petition in the appropriate United States district court. The petition must be verified and contain a concise statement of the facts supporting removal. Copies of the process, pleadings, and orders of the state court must accompany the petition. In civil cases the petition must be filed within twenty days after receipt of the initial pleading or service of the summons, depending upon the circumstances, and must be accompanied by a bond sufficient to reimburse the plaintiff-respondent for expenses incurred because of the removal proceedings if the district court

[8] 28 U.S.C. § 1443 (1958).
[9] Act of Mar. 3, 1875, ch. 137, § 5, 18 Stat. 472.
[10] Act of Mar. 3, 1887, ch. 373, § 2, 24 Stat. 552.
[11] MOORE, COMMENTARY ON THE U.S. JUDICIAL CODE, ¶ 0.03(43) (1949).
[12] Act of May 24, 1949, ch. 139, § 84, 63 Stat. 102.
[13] 78 Stat. 266, 28 U.S.C.A. § 1447(d) (Supp. 1964).
[14] 28 U.S.C. § 1446 (1958).

remands. In criminal cases no bond is required, and the petition may be filed anytime before trial. In any case, if the defendant is actually in custody, a writ of habeas corpus will issue and the United States Marshal assumes custody of the petitioner. After the petition is filed the petitioner must give written notice to all adverse parties and file a copy of the petition in the state court. The latter act effects removal, and the state court is then powerless to proceed.

The procedural steps are relatively simple, but the courts have required almost literal compliance:[15] facts, rather than conclusions, must be alleged in the petition, and those facts must set forth a proper basis for removal under the section of the statute relied upon by the petitioner;[16] this is particularly true in criminal cases;[17] the twenty day time limit in civil actions has been held to be a clear legislative expression that standardization is to be enforced;[18] in a criminal case, the action must have been commenced, *e.g.*, arrest alone is not sufficient if an information has not yet been issued;[19] in all, "strict compliance with the express provisions of the statute is required."[20]

These historical and procedural aspects of removal are not of present concern, however, nor are the pragmatic arguments for or against removal. The latter have been the subject of extensive study and publication. The conclusion usually drawn is that so many variables are involved that no general rule can be formulated.[21] The critical points for consideration here are con-

[15] 1A MOORE, ¶ 0.168[3.-1].

[16] Chesapeake & O. Ry. v. Cockrell, 232 U.S. 146 (1914); Smith v. Southern Pac. Co., 187 F.2d 397 (9th Cir.), *cert. denied*, 342 U.S. 823 (1951); Gratz v. Murchison, 130 F. Supp. 709 (D. Del. 1955).

[17] Maryland v. Soper, 270 U.S. 9 (1926); North Carolina v. Jackson, 135 F. Supp. 682 (M.D.N.C. 1955).

[18] Richlin Advertising Corp. v. Central Fla. Broadcasting Co., 122 F. Supp. 507 (S.D.N.Y. 1954).

[19] Michigan v. Banning, 88 F. Supp. 449 (E.D. Mich. 1950).

[20] Kovell v. Pennsylvania R.R., 129 F. Supp. 906, 908 (N.D. Ohio 1954).

[21] Some arguments which have been advanced are: (for removal) the quality of jurors is higher in federal courts; federal juries return smaller verdicts; federal rules of joinder are more liberal in states still bound to code pleading; appeals in federal cases are generally confined to appeals from final judgments; the federal judge has greater control over the jury, for example by being able to comment upon the evidence; the federal jury must be unanimous, absent agreement of the parties; *et cetera;* (against removal) in some jurisdictions federal juries return larger verdicts; state court judges have less discretion and are more susceptible to appellate reversal; the *Erie-*

cerned with the strategic implications of this amendment which provides for review of orders remanding certain cases to the state court. What tactical advantage can be gained or lost? What cases will be affected?

Assuming that the pragmatic factors affecting the desirability of removal are balanced, the overwhelmingly significant aspect of the availability of review of the remand order is that *time will be consumed in the appeal procedure.* This problem was considered in the congressional debates on the Civil Rights Act of 1964.[22] Senator Sparkman pointed out specifically that cases could be "tied up for long periods of time on appeals and other Federal proceedings on the Federal interest allegation that they pertain to equal protection of the laws or civil rights."[23] It was also said that the then existing law denying appeal after a remand order arose out of the fact that such appeals delayed trial, and that state laws could not be enforced while the appeal was pending.[24] Arguing along the same lines, Senator Byrd of West Virginia said that the new provision opened the door to dilatory tactics which might frustrate state law enforcement.[25] Summing up this point of view, Senator Morton stated that:

> [T]itle IX . . . contains probably the most radical departure from Federal rules and procedures of the entire bill. . . .
>
> Any lawyer can easily see that jurisdiction of any given State court could be virtually stalled while endless litigation was carried forth in the Federal courts appealing adverse decisions all the way to the Supreme Court of the United States.[26]

In answering these arguments, proponents of the bill admitted that some delay would occur but felt that this was a small price

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*Tompkins* doctrine gives no advantage in the application of substantive law; pre-trial discovery procedures may be avoided; the state docket may be more congested and allow more time before trial for a favorable settlement; the jury will be selected from a more localized area in state court; *et cetera.* See, *e.g.,* 1A MOORE, ¶ 0.157 [13]; Rogers, *Problems of Removal of Causes from State to Federal Courts,* 22 U. Kan. City L. Rev. 78 (1953).

[22] See note 4 *supra.*

[23] 110 CONG. REC. 11320-21 (1964).

[24] *Id.* at 13468 (remarks of Senator Ervin). That all review of orders to remand is prohibited by statute, including review on mandamus, to obviate delay is announced judicially by Judge John Johnston Parker in *Ex parte* Bopst, 95 F.2d 828 (4th Cir. 1938).

[25] 110 CONG. REC. 13879 (1964).

[26] *Id.* at 14459. See also *id.* at 6451 (remarks of Senator Dirksen).

to pay for "ensuring the proper administration of the removal remedy provided by Congress."[27]

Reports in at least one national news magazine indicate that opportunities will not be wasted:

> [T]here is a prickly prospect that federal courts may be deluged with every single state case bearing the slightest alleged connection to civil rights. In short, Title IX might turn out to be a gateway through which much state-court business will vanish.
>
> Civil rights leaders are ecstatic at the possibilities. "It's a tremendous device—how to screw up the system in one easy lesson," says a Florida lawyer. "Anyone who wants to can delay a case for two years."[28]

It is possible that the last statement is exaggerated, but there can be no question that the dockets of the federal courts are crowded and that litigation can be delayed. During fiscal year 1962 the following statistics were recorded: median time of eight months from filing to disposition of civil matters not requiring trial action (district courts);[29] median time of seven months from filing of a complete record to final disposition (courts of appeal);[30] median time of one and one-half months in civil cases and two months in criminal cases from filing of notice of appeal in the lower court to filing of a complete record in a court of appeal;[31] median time of twenty-six months in civil cases and eighteen months in criminal cases from docketing in the lower court to final disposition in courts of appeal.[32] Time studies are not available reflecting the status of the Supreme Court docket, but at the end of the October term of 1962 that docket was behind 474 cases, an increase of over ten per cent from the previous year.[33] Obviously, delay will be present when a case is taken into the appellate courts. It was argued in the Senate that this time would be cut to a minimum, for when the defendant-petitioner asks the court of appeals to stay the remand order of the district court the case will be examined and this examination will disclose whether removal was clearly improper and, if it was, the stay will be

[27] *Id.* at 6955 (remarks of Senator Dodd).
[28] Time, Oct. 30, 1964, p. 88.
[29] 1963 DIR. OF ADMIN. OFFICE U.S. COURTS ANN. REP. 209.
[30] *Id.* at 192.
[31] *Id.* at 193.
[32] *Ibid.*
[33] *Id.* at 178.

denied.[34] In short, the argument is that preliminary appellate determination can effectively avoid abuse of the statute.[35]

Even minimal delay, however, may result in deterioration of evidence,[36] or place an emphasis on the desirability of settlement or dismissal,[37] or allow state subpoenas to expire,[38] or have any one of an almost unlimited number of debilitating effects upon the adverse party. Thus, it would be profitable for a "civil rights" group using means that are, in fact, violent to avoid a hearing on a temporary restraining order issued by a state court by petitioning for removal to federal court and delaying the finality of decision, by the appeal procedure if necessary, until after the return date on subpoenas issued by the state court. In the meantime, arrangements could be made for key witnesses to avoid later service of process.[39] It would likewise be advantageous for a gambler free on bail and charged with contempt of the state court for refusing to testify before a local grand jury to petition for removal to federal court and appeal an order remanding the case.[40] It is to be expected that defense counsel for many reasons, proper or improper, will attempt to shield their clients behind the delaying buttress of appeal from an order remanding to state court. This may be accomplished merely by an allegation that the defendant's civil rights will be violated in the state court.

It is now well settled that a state statute or constitution that, on its face, deprives a defendant of his civil rights provides a solid basis for removal to federal court.[41] The legislative history of the amending statute would clearly seem to call for the federal courts to now extend the right to remove to members of minority groups who show that their defense in pending litigation is affected by local prejudice, or by systematic exclusion from juries, or for any reason involving the unconstitutional *application* of state laws.[42]

[34] 110 CONG. REC. 6956 (1964) (remarks of Senator Dodd).

[35] *Ibid.*

[36] ZEISEL, KALVEN & BUCHHOLZ, DELAY IN THE COURT, at xxii (1959). The state could minimize this danger, however, by adopting a practice similar to FED. R. CIV. P. 26 providing for depositions pending the action.

[37] ZEISEL, KALVEN & BUCHHOLZ, *op. cit. supra* note 36, at xxii.

[38] 110 CONG. REC. 2771 (1964) (remarks of Representative Poff).

[39] *Id.* at 2772-73 (remarks of Representative Dowdy).

[40] See Time, Oct. 30, 1964, p. 88.

[41] Virginia v. Rives, 100 U.S. 313 (1880). See generally 1A MOORE, ¶ 0.165.

[42] 110 CONG. REC. 6551, 6995 (1964) (remarks of Senators Humphrey and Dodd).

The legislative history also calls specifically for the courts to redetermine the scope of the right to remove under section 1443.[43] Probably the most significant question to be determined is whether "civil rights" and "due process" are synonymous for this purpose.

The district courts have, in many instances, remanded litigation which involved a denial of due process rather than the traditional area of civil rights, race relations. For example, cases wherein testimony before a state legislative committee was used to obtain an indictment against the witness,[44] wherein state law did not allow a defendant to challenge a member of the grand jury after the juror had been sworn,[45] wherein failure to obtain trial in state court resulted from inability to secure an attorney,[46] and wherein it was claimed that the city ordinances under which the defendants were charged were vague and indefinite[47] have all been returned to the state courts. Would the federal appellate courts now reverse any or all of the orders to remand in these cases?

New, unresolved questions of due process are certain to arise. For example, a case[48] decided in a federal circuit court held that a defendant testifying in his own behalf as to one element of the offense charged may not be cross-examined as to another element since this would amount to requiring the witness to testify against himself in derogation of the fifth amendment. The case has been cited with approval by the Supreme Court.[49] North Carolina holds that once a defendant testifies in his own behalf he opens himself to cross-examination on all issues, the constitutional right having been waived.[50] The Court of Appeals for the Fourth Circuit has never decided a case involving these facts, nor has the Supreme Court directly considered whether due process is denied in this situation. Would a federal court in North Carolina allow removal on the petition of a defendant who alleged that he would be denied due process in a state court because he anticipated testifying about part of the charge against him but not all, in view of this conflict? If not, would a federal appellate court reverse?

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[43] *Ibid.*
[44] New Jersey v. Weinberger, 38 F.2d 298 (D.N.J. 1930).
[45] New Jersey v. Corrigan, 139 Fed. 758 (C.C.N.J. 1905).
[46] Scott v. R.D. Kinney & Co., 137 Fed. 1009 (C.C.E.D. Pa. 1905).
[47] City of Birmingham v. Croskey, 217 F. Supp. 947 (N.D. Ala. 1963).
[48] Tucker v. United States, 5 F.2d 818 (8th Cir. 1925).
[49] Raffel v. United States, 271 U.S. 494 (1926).
[50] State v. O'Neal, 187 N.C. 22, 120 S.E. 817 (1924).

The questions can be answered only by the federal courts. This is exactly the point. The range of cases that can plausibly be argued, to the Supreme Court if necessary, on the basis of "civil rights" is limited only by the imagination of counsel and his sense of ethics. A uniform federal policy may emerge as a result of the legislation, but a means of delay is now readily available to all who would use it. Future events must be weighed. If the balance is uneven because abuse becomes widespread it is to be hoped and expected that the scope of the statute will be limited by legislation or judicial action.

ROBERT A. MELOTT

**Securities Regulation—Rule 10b-5—A Federal Corporations Law?**

The plaintiff, a corporate director, brought a derivative action in a federal district court against six of his co-directors, alleging a violation of rule 10b-5.[1] This rule makes it unlawful for *any* person to use any instrumentality of interstate commerce or any facility of the securities exchanges to (1) "employ any device, scheme, or artifice to defraud," or (2) "to make any untrue statement of a material fact or to omit to state a material fact . . . or" (3) "to engage in any act . . . or course of business which . . . would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."[2] The defendants allegedly sought to perpetuate their control by causing the corporation to issue treasury stock to one of the defendants individually or to a third person who would vote the stock as directed by the defendants. The fraudulent aspects of the

[1] 17 C.F.R. § 240.10b-5 (1949). Rule 10b-5 was promulgated by the Securities and Exchange Commission pursuant to § 10(b) of the Securities Exchange Act of 1934, 48 Stat. 891, 15 U.S.C. § 78j(b) (1958).

[2] The entire rule provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
> (a) To employ any device, scheme, or artifice to defraud.
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1949).

issuance were the alleged withholding from the board of the latest financial statements, the arbitrarily ascribed value of the stock, and the postponement of the annual shareholders' meeting. The plaintiff sought to have the issuance enjoined, but the action was dismissed on the ground that the court lacked jurisdiction of the subject matter.[3] The Court of Appeals for the Second Circuit, in *Runkle v. Roto American Corp.*,[4] reversed, finding the plaintiff had alleged a claim for relief over which the district court had jurisdiction.

While the history of rule 10b-5 has involved critical questions of interpretation and application,[5] it has evolved as the major anti-

[3] Jurisdiction is provided in § 27 of the Securities Exchange Act of 1934, 48 Stat. 902, 15 U.S.C. § 78aa (1958):

> The district courts of the United States . . . shall have exclusive jurisdiction of violations of this chapter or the rules . . . thereunder . . . . Any suit or action to enforce any liability or duty created by this chapter or rules . . . 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 in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. . . .

In the principal case, the lower court's decision to dismiss for lack of jurisdiction was based upon Birnbaum v. Newport Steel Corp., 98 F. Supp. 506 (S.D.N.Y. 1951), *aff'd*, 193 F.2d 461 (2d Cir. 1952), *cert. denied*, 343 U.S. 956 (1952). What the court probably meant was that the plaintiff had failed to state a claim upon which relief could be granted. The court undoubtedly had jurisdiction of the subject matter under Bell v. Hood, 327 U.S. 678 (1946), since the plaintiff had stated a claim arising under the laws of the United States. The court of appeals could therefore have reversed the dismissal purely on the jurisdictional question without reaching the merits of the case. See generally WRIGHT, FEDERAL COURTS §§ 17-19 (1963).

[4] CCH FED. SEC. L. REP. ¶ 91455 (2d Cir. Dec. 4, 1964).

[5] The problems initially encountered by the courts where whether or not the rule provided a private right of action and whether or not the rule afforded the purchaser this right of action. The courts found that a private right of action was implied by the rule. Kardon v. National Gypsum Corp., 73 F. Supp. 798 (E.D. Pa. 1947). In J. I. Case Co. v. Borak, 377 U.S. 426 (1964), the Supreme Court held that a private right of action was implied under § 14(a) of the Securities Exchange Act of 1934, 48 Stat. 893, 15 U.S.C. § 78a (1958), (proxy solicitation provision) and thereby eliminated any remaining doubts in this area. The private right of action was predicated on the principles set forth in RESTATEMENT, TORTS § 286 (1934). See generally 3 Loss, SECURITIES REGULATION 1682-1861 (2d ed. 1961); Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. U.L. REV. 627 (1962); 61 HARV. L. REV. 858 (1948); Comment, 32 TEXAS L. REV. 197 (1953); Comment, 59 YALE L.J. 1120 (1950). The courts then held that the private right of action was not only afforded to the seller but also to the purchaser. See, *e.g.*, Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961). Although the purchaser's private right of action was broadly based on public policy, it had theretofore been thought that the purchaser's rights were exclusively vested in the other provisions

fraud remedy for both purchasers and sellers of securities. The requisite elements of a 10b-5 action are far fewer than its common law counterpart of fraud and deceit.[6] The essential requirements are a misrepresentation or omission of a material fact[7] and detrimental reliance[8] on such by the party bringing suit. The transaction must have used, either directly or indirectly, an instrumentality of interstate commerce,[9] *e.g.*, a telephone,[10] the mails, or the facilities of a securities exchange, *and* must have been "in connection with the purchase or sale of any security." The security involved need not be a stock or bond, for the act's definition of "security" is exceedingly broad.[11]

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of the 1933 and 1934 acts. But the court in Fischman v. Raytheon Mfg. Co., 9 F.R.D. 707 (S.D.N.Y. 1949), *aff'd in part, rev'd in part*, 188 F.2d 783 (2d Cir. 1951), held that even though the plaintiff had a right under § 11 of the 1933 act, when there was added the ingredient of fraud, then the action could be maintained under 10b-5 whether or not he could maintain a suit under § 11 or some other provision of the act. See Ellis v. Carter, *supra*. Another pressing problem was that of the statute of limitations, since neither § 10(b) of the act nor the rule provided for one. But it has been held that the statute of limitations for the state in which the court is sitting is applicable to 10b-5 actions. Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 356 U.S. 814 (1961); Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953); Connelly v. Balkwill, 174 F. Supp. 49 (N.D. Ohio 1959). The courts have further held that the defenses of waiver, estoppel, and laches are available to the defendant. See Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962). See generally 73 YALE L.J. 1477 (1964). Note that it is still significant that the private right of action is predicated in tort. See Crist v. United Underwriters, Ltd., 230 F. Supp. 136 (D. Colo. 1964), where the court held that a private right of action under 10b-5 cannot be transmuted into an action on a contract, express or implied, which will sustain attachment against a resident defendant, even though restitution rather than a damage remedy was sought.

[6] At common law the elements of deceit were (1) a false representation of (2) a material (3) fact; (4) the defendant must know of the falsity (*scienter*) but make it, nevertheless, for the purpose of inducing the plaintiff to rely upon it, and the (5) plaintiff must justifiably rely upon it to his (6) damage. For a comparison between the common law elements and those of rule 10b-5, see 3 Loss, *op. cit. supra* note 5, at 1431.

[7] Kremer v. Selheimer, 215 F. Supp. 549 (E.D. Pa. 1963); Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962); In the Matter of Cady, Roberts & Co., 40 S.E.C. 907 (1961). See generally 3 Loss, *op. cit. supra* note 5 at 1430-44.

[8] See Howard v. Furst, 283 F.2d 790 (2d Cir. 1956), *cert. denied*, 353 U.S. 973 (1957); Mills v. Sarjem Corp., 133 F. Supp. 753 (D.N.J. 1955). *Cf.* Kremer v. Selheimer, *supra* note 7.

[9] Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953); Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951).

[10] See Fratt v. Robinson, *supra* note 9.

[11] See Securities Act of 1933 § 2, 48 Stat. 74, 15 U.S.C. § 77b(1) (1958). It provides that the term "security" includes such things as any note, stock,

In *Roto* the requirement "in connection with the purchase or sale" takes on particular significance since there was only an issuance of treasury stock involved. The court reasoned that the issuance of stock by the corporation was a sale for the purposes of 10b-5. However, in early 10b-5 litigation this would have indeed been a novel idea.[12] The argumentum against the equation of sale to issuance was based upon the SEC's power to regulate. The basis of the power was two-fold: (1) to regulate in the interest of the public and (2) to regulate for the protection of the investor. The argument asserted that the corporation was not an investor in its own stock and, therefore, the rules were not promulgated for its protection.[13] The courts rejected this in favor of the public policy grounds of regulation, which were found to encompass protection to an issuing corporation.[14] The principle of equating an issuance to a sale is now firmly established. The courts have given the corporation standing to effectuate the protection by permitting it to bring the action itself and by allowing derivative actions. The court in *Roto* recognized a necessity for this standing by stating:

> Barring suit by a corporation defrauded under those circumstances would, as a legal and practical matter, destroy any remedy against the perpetrator of the fraud. Suits by individual shareholders would either run afoul of the *privity requirements* . . . or result in smaller recoveries . . . .[15]

The privity requirement referred to by the court has been a source of judicial controversy since its introduction as a requisite

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fractional undivided interest in oil, gas or other mineral rights, or any interest or instrument commonly known as a security.

[12] Hooper v. Mountain States Sec. Corp. 282 F.2d 195 (5th Cir. 1960), *cert. denied,* 356 U.S. 814 (1961).

[13] *Ibid.*

[14] *Ibid. Hooper* is apparently the first case extending 10b-5 protection to an issuing corporation. The court said:

> It greatly expands the protection frequently so hemmed in by the traditional concepts of common law misrepresentation and deceit, the requirement of privity, proof of specific damage, inadequacy of the right of rescission or right to recover up to par value of stock of a much greater market value.

282 F.2d at 201. The inadequacy of a common law remedy and the proof requirements were the prime reasons for extending the protection. For other cases implying a private right of action for the issuing corporation, without discussing the problem, see New Park Mining Co., v. Cranmer, 225 F. Supp. 261 (S.D.N.Y. 1963); Pettit v. American Stock Exch., 217 F. Supp. 21 (S.D.N.Y. 1963).

[15] CCH FED. SEC. L. REP. ¶ 91455, at 94769. (Emphasis added.)

to a private right of action. It was first interjected when the court in *Joseph v. Farnsworth Radio & Television Corp.*[16] unfortunately stated:

> A *semblance of privity* between the vendor and purchaser of the security in connection with which the improper act, practice or course of business was invoked seems to be requisite and it is entirely lacking here.[17]

The privity with which the court was there concerned was privity of contract. In other words, for a private right of action to exist, the misrepresentation or omission must have been that of either a purchaser or seller and not that of a third person. The doctrine of privity prohibited either the purchaser or seller from suing a third party if he was not an immediate party to the transaction.[18] However widespread the necessity of privity became, it is now fairly apparent that it is no longer requisite to a private right of action under 10b-5.[19] Today, privity is generally recognized as an evidentiary fact to be considered in conjunction with other material facts in determining whether the duty created by 10b-5 was breached.[20] However, there is a trend towards its total rejection for any purpose.[21] The courts adopting the trend permit a suit by either purchaser or seller against any party making a misrepresentation, even though he was not a party to the immediate transaction. The question of privity was not before the court in *Roto,* but its references

[16] 99 F. Supp. 701 (S.D.N.Y. 1951), *aff'd,* 198 F.2d 883 (2d Cir. 1952).

[17] 99 F. Supp. at 706. (Emphasis added.)

[18] The courts, in an effort to lessen the effect of privity and to extend the scope of 10b-5, permitted a charge of conspiracy to sweep in peripheral defendants. It is only necessary, therefore, for the plaintiff to prove that one of the defendants was in privity with him, either as a purchaser or a seller. See, *e.g.,* Errion v. Connell, 236 F.2d 447 (9th Cir. 1956); Thiele v. Shields, 131 F. Supp. 416 (S.D.N.Y. 1955).

[19] See New Park Mining Co. v. Cranmer, 225 F. Supp. 261 (S.D.N.Y. 1963); Pettit v. American Stock Exch., 217 F. Supp. 21 (S.D.N.Y. 1963); Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962); Texas Continental Life Ins. Co., v. Bankers Bond Co., 187 F. Supp. 14 (W.D. Ky. 1960), *rev'd on other grounds,* 307 F.2d 242 (6th Cir. 1962); H. L. Green Co. v. Childree, 185 F. Supp. 95 (S.D.N.Y. 1960).

[20] Brown v. Bullock, 194 F. Supp. 207, 229-30 (S.D.N.Y. 1961), *aff'd,* 294 F.2d 415 (2d Cir. 1961).

[21] See cases cited in note 19 *supra.* The proclivity of the courts toward privity is lucidly shown in Miller v. Bargain City, U.S.A., Inc., 229 F. Supp. 33 (E.D. Pa. 1964), where the court, in making the latest pronounciamento on the privity requirement, said: "I find it unnecessary to attempt a definition of this, at best, cloudy phrase, for if 'a semblance of privity' means 'privity' (like 'a little bit pregnant'), I reject it." *Id.* at 37.

to privity as a requirement and to *Farnsworth* apparently mean that it rejects the present trend. Such a result will not afford the investor the maximum protection against *any* person who has defrauded him in connection with the purchase or sale of a security.

Although *Roto* did not reject the privity requirement, it did reject, for the purposes of this case, and perhaps for all 10b-5 actions, the doctrine that the directors constitute the corporation. The rejection was out of necessity, for otherwise the result would have been that the corporation had defrauded itself. The result is, of course, justifiable since it prohibits directors from taking advantage of their fiduciary capacity. *Roto* is not clear as to the percentage of directors who voted in favor of the issuance, but it is fair to assume that a majority so voted. If such actually was the case, the court's rejection of the doctrine seems to require a conceptualistic realignment of fictions, for it has been held in other contexts that board action is corporate action.[22]

*Roto* is not important because it expands the interpretation of any single element of a 10b-5 action, but rather because it exemplifies the widening application of the rule to acts of corporate mismanagement and breaches of fiduciary duties. The growing latitude of application is succinctly stated by the court:

> It is no answer simply to state that the federal security laws are not concerned with corporate mismanagement or breaches of fiduciary obligations. That Congress could not or did not attempt to resolve all corporate ills, does not mean that it chose to leave without the federal sphere problems *basic to the entire regulatory system.*[23]

This statement in juxtaposition with the corporation's standing to sue and the rejection of privity by other courts gives rise to the implication that 10b-5 is more than an anti-fraud rule; it is a substantive federal corporations law.[24]

The idea of a federal corporations law based on 10b-5 was rejected in *Birnbaum v. Newport Steel Corp.*[25] In that case the majority shareholder of Newport sold his controlling interest to Wilport Co. at a premium, making misrepresentations to the minority share-

[22] See, *e.g.*, Baltimore & O. R.R., v. Foar, 84 F.2d 67 (7th Cir. 1936).

[23] CCH FED. SEC. L. REP. ¶ 91455, at 94769. (Emphasis added.)

[24] See Ruder, *Pitfalls in the Development of a Federal Law of Corporations by Implication Through Rule 10b-5,* 59 NW. U.L. REV. 185 (1964).

[25] 98 F. Supp. 506 (S.D.N.Y. 1951), *aff'd,* 193 F.2d 461 (2d Cir. 1952), *cert. denied,* 343 U.S. 956 (1952).

holders of Newport about a previous offer from another company. The minority shareholders alleged that the misrepresentations constituted a violation of 10b-5. The court, instead of finding a violation, took the narrow approach that the rule was aimed only at a fraud perpetrated on the buyer or seller and had no relation to breaches of fiduciary duty resulting in fraud on the minority.[26] This approach was taken before the introduction of privity, and one commentator[27] has concluded that the privity requirement as represented by *Farnsworth* was nothing more than an effort to keep the question of corporate mismanagement in the state courts.

Notwithstanding *Birnbaum* and the privity requirement, the limits of application of 10b-5 have greatly expanded. The duty of disclosure under 10b-5 has been applied to the "insider," traditionally a director, officer, or controlling shareholder.[28] But the SEC in *In The Matter of Cady, Roberts & Co.*[29] rejected the "insider" concept as a limit to the duty to disclose and instead rested the obligation of disclosure[30] upon two principal elements:

[26] For another approach to this case, see Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955). For a discussion of corporate opportunities, see 74 HARV. L. REV. 765 (1961).

[27] Leech, *Transactions in Corporate Control,* 104 U. PA. L. REV. 725, 786 (1956). See generally 3 Loss, *op. cit. supra* note 5, at 1763-70.

[28] See Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951).

[29] 40 S.E.C. 907 (1961). For comments on this case, see 30 U. CHI. L. REV. 121 (1962); 71 YALE L.J. 736 (1962). The defendant in this case was stock brokerage firm. One of the members was also the director of a corporation listed on an exchange. Immediately after the corporation voted to reduce its dividend, the director-associate relayed the information to the defendant. Aware of the dividend reduction, defendant sold the stock of the corporation held in discretionary accounts before news of the reduction reached the exchange. When news of the reduction did reach the exchange, a decline in the market resulted. Failure to disclose the reduction to the purchaser was found to be a violation of 10b-5. Here, there was no intent to defraud, since normally the news would have already reached the exchange except for the unexplained delay in communication.

[30] In Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951), the court's rationale foreshadowed that of the SEC in *Cady, Roberts,* but seems to have been limited to the "insider" concept, which was rejected by the Commission. The court said:

> The rule is clear. It is unlawful for an insider, such as a majority stockholder, to purchase the stock of minority stockholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his position but not known to the selling minority stockholder, which information would have affected the judgment of the sellers. The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his position to take unfair advantage of the uninformed minority stockholder.

*Id.* at 828-29. The test as to what information need be disclosed seems to

> [F]irst, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.[31]

The SEC found that the anti-fraud provisions were not intended as a specification of particular acts of fraud, but rather as an encompassment of an infinite variety of forms and devices used to take advantage of investors. The expansion of the duty to disclose seems justifiable since it affords maximum protection to the investor.

Expansion in yet another direction is represented by *New Park Mining Co. v. Cranmer*,[32] where an insider took advantage of opportunities rightfully belonging to the corporation. Here, a corporation sued a director, alleging three separate violations of the rule, each involving a separate transaction. In the first transaction, the defendant was negotiating the acquisition of stock in a new venture for the corporation. Instead of acquiring all of the offered stock for the corporation, he was able to appropriate for himself a sizeable portion without consideration. The court found that this was a fraud on the corporation because the defendant's acquisition proportionately reduced the value of the shares acquired by the corporation. In the second transaction the defendant induced a third party to acquire mining leases, which had been offered to the corporation, in the names of the third party and of the corporation. Again the corporation furnished the sole consideration, and was defrauded by purchasing the third party's interest for 40,000 shares of its own stock, of which 11,000 went to the defendant. Within the same time scope, the corporation was allegedly defrauded by its purchase, at an inflated price, of its own stock from another third party. This purchase was facilitated by the defendant. Both acts in the second

be inherent in *Speed*, viz., that information which would affect the judgment of either the buyer or seller. At common law there was a duty to disclose "special facts" which used essentially the same test implied in *Speed*. Strong v. Repide, 213 U.S. 419 (1909). The test should apply a reasonable man standard in determining which facts would affect the judgment, otherwise it becomes subjective and allusive. See Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963). See generally 3 Loss, *op. cit. supra* note 5, at 1456-66; 62 MICH. L. REV. 880 (1964).

[31] 40 S.E.C. at 912.

[32] 225 F. Supp. 261 (S.D.N.Y. 1963).

transaction constituted a single violation of 10b-5. In the third transaction, the corporation was allegedly defrauded by the defendant's failure to disclose to the corporation the fact that the defendant was to have an interest in a venture that the corporation was to enter with another company. The corporation lost a considerable amount of money in exploration of the proposed venture, which proved to be worthless. The court found that the agreement to purchase the half interest was itself a purchase for the purposes of 10b-5. Note that in none of the transactions did the defendant deal directly with the corporation. The court said of the entire sequence of events:

> A purchaser or seller of stock is not limited under Section 10(b) and Rule 10b-5 to an action against the other party to the purchase or sale; he can sue a third party if in connection with the purchase or sale that person defrauded him. . . . It is immaterial whether the purchase or sale was part of a larger scheme of corporate mismanagement if the elements of a claim under Section 10(b) and Rule 10b-5 are otherwise present.[33]

The court was apparently willing to take cognizance of the entirety of each transaction and not merely the 10b-5 violations. It is doubtful that the court was willing to decide *every* appendant issue, since the court was uncertain whether the money spent in exploration in the third transaction was sufficiently connected to the 10b-5 violation to permit recovery for the loss. This uncertainty implies that the court was willing to apply a test of proximity, but it is difficult to ascertain the degree of proximity necessary to justify deciding an appendant issue.

Another approach generally taken in this area is that of invoking the doctrine of pendent jurisdiction,[34] which permits a federal court to decide non-federal claims when the non-federal claim arises out of the same cause of action as a federal claim.[35] This has traditionally meant that the federal and non-federal claims constitute nothing more than a shift in the theory of recovery. The difficulty with this approach lies in the fact that not all acts of corporate mismanagement and breaches of fiduciary duty can be said to arise out of the same cause of action as that arising from

[33] *Id.* at 266.

[34] Hurn v. Oursler, 289 U.S. 238, 245-46 (1933).

[35] *Ibid.* See generally WRIGHT, *op. cit. supra* note 3, §§ 19, 78; 62 COLUM. L. REV. 1018 (1962).

the violation of the rule, and the courts would not have jurisdiction of such claims under the doctrine of pendent jurisdiction.[36]

A third view would be to consider the acts of corporate mismanagement, in which the elements of 10b-5 are present, as "basic to the entire regulatory system," and therefore, covered by the rule itself.[37] Thus, once the elements of 10b-5 have been established, the court will be able to decide all of the collateral questions without the restriction imposed by pendent jurisdiction. The merits of this view are the relative ease of deciding the jurisdictional problems and the avoidance of piecemeal litigation. The basis of this view is in the assertion that 10b-5 is a federal substantive corporations law. Such an assertion is supported by *Roto,* and by the following language which foreshadowed *Roto:*

> It creates many managerial duties and liabilities unknown to the common law. It expresses federal interest in management-stockholder relationships which theretofore had been almost exclusively the concern of the states. . . . Section 10(b) provides stockholders with a potent weapon for enforcement of many fiduciary duties. It can be said fairly that the Exchange Act . . . constitutes far reaching federal substantive corporation law.[38]

This approach represents a substantial change of attitude from that expressed in *Birnbaum,* which now stands only for the proposition that third parties cannot assert claims based upon a sale or purchase to which they were not a party.[39] How much greater the lattitude will become for calling collateral problems "problems basic to the entire regulatory system" is open to speculation.

That 10b-5 has become a federal substantive corporation law is apparent. Whether or not the rule itself is a sufficient basis for such law is open to serious debate. At this stage in its expansion, it would seem appropriate for the courts to apply at least a quantum of restraint before the body of law developing appurtenent to the rule, for deciding the collateral issues, becomes too encom-

[36] See, *e.g.,* Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Wolfson v. Blumberg, 229 F. Supp. 192 (S.D.N.Y. 1964).

[37] It is possible to state this in another way, namely, that a breach of fiduciary duty is a genus of fraud which the courts are willing to treat under the anti-fraud provisions, even though not traditionally considered a "fraud." *Cf.* S.E.C. v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

[38] McClure v. Borne Chem. Co., 292 F.2d 824, 834 (3d Cir.), *cert. denied,* 368 U.S. 939 (1961).

[39] See Kremer v. Selheimer, 215 F. Supp. 549 (E.D. Pa. 1963).

passing. If, in view of the growth of large interstate corporations and the basic structure of the American economy, a federal corporations law would be advantageous or desirable,[40] then it is for Congress to so provide.

THOMAS C. WETTACH

**Torts—Implied Warranty—Privity**

The overwhelming majority of jurisdictions reject the requirement of privity of contract between the consumer of a product and the manufacturer in an action on an implied warranty.[1] In *Terry v. Double Cola Bottling Co.*,[2] North Carolina retained its rule requiring privity. The court there affirmed a compulsory nonsuit in an action against the manufacturer where the plaintiff's evidence showed that she had purchased from a lunchroom, an intermediate seller, a bottled drink allegedly containing a green fly.[3] However, Justice Sharp, in a thorough concurring opinion,[4] attacked the food manufacturers' fortress of privity under the present North Carolina law and urged the court to adopt the majority rule. This case presents the question: is it necessary to abandon the privity requirement in order to provide adequate remedies for an injured consumer or ultimate user?

At common law, the courts required privity of contract in a negligence action against the manufacturer.[5] However, when manufacturers began making extensive use of distributors and retailers to peddle their products to the public, the courts realized the injustice of this requirement.[6] The initial onslaught began in *Mac-*

[40] Some of the obvious advantages would be in the relative ease of obtaining service of process, the jurisdictional requirements, and the most important would be that of uniformity. For the problems appendant to 10b-5 as a corporation law, and its effect on such things as the stock market, directors, etc., see Ruder, *supra* note 24.

[1] Prosser, *The Assault Upon the Citadel (Strict Liability to the Consumer)*, 69 YALE L.J. 1099 (1960). Dean Prosser stated that no state has adopted this privity requirement since 1935 but many have rejected it. *Id.* at 1110.

[2] 263 N.C. 1, 138 S.E.2d 753 (1964).

[3] *Id.* at 3, 138 S.E.2d at 754.

[4] *Id.* at 3, 138 S.E.2d at 754. Justice Sharp concurred because she found a lack of evidence that the fly was in the bottle when it left the defendant's control.

[5] Winterbottom v. Wright, 10 M. & W. 109, 152 Eng. Rep. 402 (Ex. 1842).

[6] See generally Prosser, *supra* note 1.

*Pherson v. Buick Motor Co.*,[7] where the court discarded the need for privity in negligence actions and imposed a duty on manufacturers to make their product reasonably safe for all foreseeable users.[8] This rule has been accepted by all jurisdictions[9] and has been extended by some to protect bystanders "within the vicinity of probable use."[10]

Apart from negligence, the courts held the manufacturer liable in contract.[11] Where the manufacturer made express representations to the public about the quality of his product,[12] almost all jurisdictions have held him strictly liable to the consumer or ultimate user.[13] In absence of express warranties, the courts held a food manufacturer, packer, or processor liable to the consumer on an implied warranty only if they were in privity of contract.[14] But, because of modern merchandizing and public policy, a distinct majority of the jurisdictions completely abrogated the privity requirement and held a food manufacturer strictly liable to the ultimate consumer.[15] The courts extended this warranty to nonfood manu-

[7] 217 N.Y. 382, 111 N.E. 1050 (1916).

[8] For discussion of a manufacturer's negligence see Noel, *Manufacturer's Negligence of Design or Directions for Use of A Product*, 71 YALE L.J. 816 (1962). See generally 1 FRUMER & FRIEDMAN, PRODUCTS LIABILITY §§ 5-15 (1964).

[9] Prosser, *supra* note 1, at 1100.

[10] *E.g.*, Gaidry Motors, Inc. v. Brannon, 268 S.W.2d 627 (Ky. 1954).

[11] See generally WILLISTON, SALES § 197 (1948).

[12] Pritchard v. Liggett & Myers Tobacco Co., 295 F.2d 292 (3d Cir. 1961) (TV—"Nose, throat, and accessory organs not adversely affected by smoking Chesterfields"); Maecherlin v. Sealy Mattress Co., 145 Cal. App. 2d 275, 302 P.2d 331 (Ct. App. 1956) (billboard—"Ten Year Warranty"); Lane v. C. A. Swanson & Sons, 130 Cal. App. 2d 272, 278 P.2d 723 (Ct. App. 1955) (newspaper—"Boned Chicken"); Worley v. Procter & Gamble Mfg. Co., 241 Mo. App. 1114, 253 S.W.2d 532 (1952) (label—"Kind to Hands"); Randy Knitware, Inc. v. American Cyanamid Co., 11 N.Y.2d 5, 181 N.E.2d 339, 226 N.Y.S.2d 363 (1962) (magazine—"Will Not Shrink or Stretch Out of Fit").

[13] Only three states appear to require privity in an action on an express warranty: Barnard v. Pennsylvania Range Boiler Co., 216 F. Supp. 560 (E.D. Pa. 1963) (applying Massachusetts law) (water heater); Senter v. B. F. Goodrich Co., 127 F. Supp. 705 (D. Colo. 1954) (tire); Chanin v. Chevrolet Motor Co., 89 F.2d 889 (7th Cir. 1937) (applying Illinois law) (windshield glass).

[14] *E.g.*, Race v. Krum, 222 N.Y. 410, 118 N.E. 853 (1918).

[15] The jurisdictions of the following cases appear to require privity in food cases for an action on an implied warranty: Birmingham Chero-Cola Bottling Co. v. Clark, 205 Ala. 678, 89 So. 64 (1921) (fly in bottle); Nelson v. Armour Packing Co., 76 Ark. 352, 90 S.W. 288 (1905) (deleterious canned tongue); *but see* Delta Oxygen Co. v. Scott, 383 S.W.2d 885 (Ark. 1964); Nehi Bottling Co. v. Thomas, 236 Ky. 684, 33 S.W.2d 701 (1930)

facturers,[16] and, again, a majority of the jurisdictions abolished privity[17] and held the manufacturer strictly liable to foreseeable users.[18] As a final step in abolishing the entire privity concept, some courts have held a manufacturer strictly liable in tort.[19]

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(soda with arsenic); Pelletier v. Dupont, 124 Me. 269, 128 A. 186 (1925) (pin in bread); Vaccarino v. Cozzubo, 181 Md. 614, 31 A.2d 316 (1943) (sausage with trichinosis); Carlson v. Turner Centre System, 263 Mass. 339, 161 N.E. 245 (1928) (glass in bottled milk); Smith v. Salem Coca-Cola Bottling Co., 92 N.H. 97, 25 A.2d 125 (1942) (glass in coke); Thomason v. Ballard & Ballard Co., 208 N.C. 1, 179 S.E. 30 (1935) (rat in sack of flour); Lombardi v. California Packing Sales Corp., 83 R.I. 51, 112 A.2d 701 (1955) (deleterious apricot juice); Whitehorn v. Nash-Finch Co., 67 S.D. 465, 293 N.W. 859 (1940) (poisonous candy); Burgess v. Sanitary Meat Market, 121 W. Va. 605, 5 S.E.2d 785 (1939) (dictum). Some of the theories utilized by the courts that have abrogated privity are: Williams v. Campbell Soup Co., 80 F. Supp. 865 (W.D. Mo. 1948) (rejected privity as against public policy); Klein v. Duchess Sandwich Co., 14 Cal. 2d 272, 93 P.2d 799 (1939) (warranty from manufacturer to retailer inured to the consumer's benefit); Davis v. Van Camp Packing Co., 189 Iowa 775, 176 N.W. 382 (1920) (manufacturer's marketing was a representation to the public that the goods are merchantable); Coca-Cola Bottling Works v. Lyons, 145 Miss. 876, 111 So. 305 (1927) (warranty runs with the goods); Madouros v. Kansas City Coca-Cola Bottling Co., 230 Mo. App. 275, 90 S.W.2d 445 (1936) (retailer assigned his warranty to the consumer); Cohen v. Dugan Bros., 134 Misc. 155, 235 N.Y. Supp. 118 (1929) (privity evaded by impleader); Ward Baking Co. v. Trizzino, 27 Ohio App. 475, 161 N.E. 557 (1928) (consumer was a third party beneficiary of the retailer's contract with the manufacturer). See generally Gillam, *Products Liability in A Nutshell*, 37 ORE. L. REV. 119, 153-54 (1958).

[16] *E.g.*, Spence v. Three Rivers Builders & Masonry Supply, Inc., 353 Mich. 120, 90 N.W.2d 873 (1958).

[17] In *addition to* the jurisdictions in note 15 *supra*, the following jurisdictions still appear to require privity in nonfood cases: Barlow v. DeVilbiss Co., 214 F. Supp. 540 (E.D. Wisc. 1963) (defective container); Larson v. United States Rubber Co., 163 F. Supp. 327 (D. Mont. 1958) (rubber boots); Jordan v. Worthington Pump & Mach. Co., 73 Ariz. 329, 241 P.2d 433 (1952) (pump); Behringer v. William Gretz Brewing Co., 53 Del. 365, 169 A.2d 249 (1961) (beer carton); Long v. Flanigan Warehouse Co., 79 Nev. 241, 382 P.2d 399 (1963) (ladder); Kennedy v. General Beauty Prods., 112 Ohio App. 505, 167 N.E.2d 116 (1960) (hair dye); Odom v. Ford Motor Co., 230 S.C. 320, 95 S.E.2d 601 (1956) (tractor lift); Kyker v. General Motors Corp., 381 S.W.2d 884 (Tenn. 1964) (defective auto engine).

[18] Henningsen v. Bloomfield Motors, Inc., 32 N.J. 358, 161 A.2d 69 (1960). The following are considered "foreseeable users:" Chapman v. Brown, 198 F. Supp. 78 (D. Hawaii 1961), *aff'd*, 304 F.2d 149 (9th Cir. 1962) (user-borrower); Simpson v. Powered Prods., Inc., 24 Conn. Supp. 409, 192 A.2d 555 (C.P. 1963) (lessee); Connolly v. Hagi, 24 Conn. Supp. 198, 188 A.2d 884 (Super. Ct. 1963) (repairman); and Jakubowski v. Minnesota Mining & Mfg. Co., 80 N.J. Super. 184, 193 A.2d 275 (1963) (employee). However, the courts refuse to extend the benefit of this warranty to the general public. Kuschy v. Norris, 206 A.2d 275 (Conn. 1964); Hahn v. Ford Motor Co., 126 N.W.2d 350 (Iowa 1964). *But see* Henningsen v. Bloomfield Motors, Inc., *supra*.

[19] Putman v. Erie City Mfg. Co., 338 F.2d 911 (5th Cir. 1964) (applying

North Carolina accepts the majority rule in only two instances —where the action is in negligence[20] and where a food manufacturer has made express warranties to the consumer.[21] As exemplified by *Terry,* the court continues to require privity of contract in an action against a manufacturer on an implied warranty.[22] However, in cases involving sealed food stuffs, North Carolina has allowed a defendant seller to join his seller; thus the manufacturer may eventually be brought in as a party defendant.[23]

A manufacturer is primarily responsible for the quality of its products; moreover, it is usually financially more able than intermediate sellers to redress harmful effects caused by its products. As has been indicated, the remedies available to an injured consumer or ultimate user against a manufacturer are limited in North Carolina. Thus the question: are they adequate?

In a negligence action, the consumer or ultimate user is aways confronted with the difficulty of proof.[24] When there is no direct evidence of negligence, a majority of the courts allow him to resort

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Texas law); Lartigue v. R. J. Reynolds Tobacco Co., 317 F.2d 19 (5th Cir. 1963) (applying Louisiana law); and Greenman v. Yuba Power Prods., Inc., 59 Cal. 2d 67, 377 P.2d 897 (1963). This view is embodied in the *Restatement of Torts,* RESTATEMENT (SECOND), TORTS § 402 A (Tent. Draft No. 10, 1964).

[20] *E.g.,* Gwyn v. Lucky City Motors, Inc., 252 N.C. 123, 113 S.E.2d 302 (1960).

[21] In Simpson v. American Oil Co., 217 N.C. 542, 8 S.E.2d 813 (1940), the court held that the statement "Amox is made for the purpose of killing insects, it is not poisonous to human beings" was an express warranty appearing on a can of insecticide. However, this express warranty exception "has been limited to cases involving sale of goods, intended for human consumption, in sealed packages prepared by the manufacturer and having labels with representations to consumers inscribed thereto." Perfecting Serv. Co. v. Product Dev. & Sales Co., 261 N.C. 660, 668, 136 S.E.2d 56, 62-63 (1964).

[22] *E.g.,* Perfecting Serv. Co. v. Product Dev. & Sales Co., *supra* note 21 (non-food); Thomason v. Ballard & Ballard Co., 208 N.C. 1, 179 S.E. 30 (1935) (food).

[23] Davis v. Radford, 233 N.C. 283, 63 S.E.2d 822 (1951). The opinion emphasized that the distributor, a remote seller, was primarily liable. *Id.* at 287, 63 S.E.2d at 826. *Davis* was limited by Perfecting Serv. Co. v. Product Dev. & Sales Co., 261 N.C. 660, 136 S.E.2d 56 (1964), where the court emphasized "that it was not intended to abandon the privity rule in all warranty cases, but the procedure approved therein was to apply only to sale of articles for human consumption sold in sealed packages prepared by the manufacturer." *Id.* at 670, 136 S.E.2d at 64.

[24] For discussion of the difficulties involved in proving negligence, see Ashe, *So You're Going to Try A Products Liability Case,* 13 HASTINGS L.J. 66 (1961).

to *res ipsa loquitur*.[25] However, North Carolina rejects this doctrine in sealed food cases and requires the consumer to show "similar instances,"[26] an almost insurmountable task.[27] In an action on an express warranty, he has to show that the representations of a food manufacturer do in fact constitute an express warranty.[28] Either because of lack of proof in negligence or lack of express warranty, the consumer or ultimate user's only relief is an action on an implied warranty. Because of the requirement of privity, he cannot sue the manufacturer and is relegated to suing his immediate seller, who may be equitably insolvent. Even under the joinder procedure in sealed food cases, he is at the mercy of his immediate seller and other interim sellers to join the manufacturer.[29] In all

[25] 1 FRUMER & FRIEDMAN, PRODUCTS LIABILITY § 12.03 (1964).

[26] Enloe v. Charlotte Coca-Cola Bottling Co., 208 N.C. 305, 180 S.E. 582 (1935). In non-food cases, it seems that the court does not require a showing of "similar instances" but allows the use of *res ipsa loquitur* if the injured user can show that the product was under the exclusive control of the manufacturer. See Wyatt v. North Carolina Equipment Co., 253 N.C. 355, 117 S.E.2d 21 (1960).

[27] Graham v. Winston Coca-Cola Bottling Co., 257 N.C. 188, 125 S.E.2d 429 (1962) (evidence that a bottle exploded without impact is not a similar instance when the plaintiff's bottle exploded on a slight impact); McLeod v. Lexington Coca-Cola Bottling Co., 212 N.C. 671, 194 S.E. 82 (1937) (evidence that two types of drinks bottled by the defendant contained foreign substances was not a similar instance when the plaintiff's drink was of a third type); Enloe v. Charlotte Coca-Cola Bottling Co., 208 N.C. 305, 180 S.E. 582 (1935) (evidence that other drinks bottled by the defendant contained a "green looking thing," a dead fly, and a piece of glass was not a similar instance when the plaintiff's bottle contained a mouse). *But see* Caudle v. F. M. Bohannon Tobacco Co., 220 N.C. 105, 16 S.E.2d 680 (1941) (evidence that a plug of tobacco, a non-sealed product, contained a rat's foot was sufficient to take the case to the jury even though the plaintiff's plug contained a fish hook).

[28] A seller's representation about the quality of his product may be considered mere "puffing". Even though he may not specifically express himself in such words as "I promise you . . ." or "This product will not . . .," the seller is constantly extolling his product as a "perfect product."

> It is to shut one's eyes and ears in today's "world of advertising" to say that, because no reassuring words appear on the product's container, the manufacturer of a nationally advertised product has made no representation to the purchaser. He makes one every day—sometimes every hour on the hour. Any [product] entitled to status as a "famous name brand" has been warranted by the manufacturer to the consumer—very probably in color!—in magazines, on billboards, and by "glamorous stars of stage and screen" over radio and television.

Terry v. Double Cola Bottling Co., 263 N.C. 1, 13, 138 S.E.2d 753, 761 (Sharp, J., concurring). However, the court must find positive express warranty. See Murray v. Bensen Aircraft Corp., 259 N.C. 638, 131 S.E.2d 367 (1963).

[29] See Davis v. Radford, 233 N.C. 283, 63 S.E.2d 822 (1951).

other instances, the consequence is a multitude of litigation of buyer against seller. Thus, in many cases, the requirement of privity leaves an injured consumer or user without redress from the manufacturer. Moreover, it could leave him without relief from anyone.

An injured consumer or user who is not in fact the buyer cannot sue the retailer on an implied warranty since there is no privity. Therefore, neither a purchaser's husband, employee, or guest can sue the retailer in absence of an agency relationship.[30] Apart from cases where the retailer of the defective product is known, the buyer may be unable to determine who was the seller of the defective product when he has made identical purchases from various retailers. Thus, in some cases, the privity requirement is an absolute bar to redress from anyone in the absence of a negligence action against the manufacturer.

The Uniform Commercial Code would provide limited relief. It abandons the privity requirement to the extent that a buyer's family, or member of his household, or guest can sue the *last seller*.[31] However, since the Code has no vitality in the distributive chain,[32] it does not change the existing case law in determining whether a buyer or those named third party beneficiaries can directly sue the manufacturer on an implied warranty. Since the North Carolina case law requires privity, the Code would be useless in allowing a

[30] In Rabb v. Covington, 215 N.C. 572, 2 S.E.2d 705 (1939), the consumer's mother purchased a package of sausage containing a piece of metal. Indicating that she purchased it for her son, the court held the retailer liable but made no reference to the agency relation.

[31] "A seller's warranty whether express or implied extends to any natural person who is in the family or household of his buyer or who is a guest in his home if it is reasonable to expect that such person may use, consume or be affected by the goods . . . ." UNIFORM COMMERCIAL CODE § 2-318. This provision was not adopted by California since their case law had already extended greater coverage than that provided by the Code. CAL. COM. CODE § 2318, comment. Moreover, even though the legislature in one state did adopt this provision, the court allowed a person not a named third party beneficiary under this provision to sue the manufacturer on a breach of an implied warranty. Thompson v. Reedman, 199 F. Supp. 120 (E.D. Pa. 1961). Some courts have construed the word "family" to include "industrial family." Delta Oxygen Co. v. Scott, 383 S.W.2d 885 (Ark. 1964). *Contra,* Hochgertel v. Canada Dry Corp., 409 Pa. 610, 187 A.2d 575 (1963).

[32] UNIFORM COMMERCIAL CODE § 2-318, comment 3 (1962 Official Text with Comments), provides that "the section is neutral and is not intended to enlarge or restrict the developing case law on whether the seller's warranties, given to his buyer who resells, extend to other persons in the distributive chain."

suit against the manufacturer. Thus, privity must be abrogated either by judicial decision or legislative enactment independent of the Code.

The court in *Terry* could have easily adopted the majority rule and eliminated privity without overruling any recent food case,[33] or it could have utilized a tort approach in holding the manufacturer strictly liable to the consumer without impeaching the privity requirement in warranty actions.[34] Moreover, it could have invoked the majority rule[35] that a violation of a pure food act[36] is negligence *per se* in a civil action.[37] But the court refused to falter.

[33] It appears that the only food case expressly requiring privity was Thomason v. Ballard & Ballard Co., 208 N.C. 1, 179 S.E. 30 (1935). However, this rule has been stated countless times by nonfood cases citing *Thomason*. The court keeps repeating their impregnable rule requiring privity and defying its common law capacity.

> [The majority rule] truly exemplified the capacity of the common law to originate, modify, abandon, extend or adjust ideas, theories and rules to meet changing conditions or achieve greater perfection in rendering justice. Those who would freeze privity at any one stage of its development are both ignoring its common-law origin as an imperfect idea in the fallible human brains of certain judges—not a divine unchanging principle in which there can be no error—and denying its common-law capacity to develop. The truth is that privity was never a static concept, and it should not now be any more static than the common-law is static . . . .

Chapman v. Brown, 198 F. Supp. 78, 104-05 (D. Hawaii 1961), *aff'd*, 304 F.2d 149 (9th Cir. 1962).

[34] In Davis v. Radford, 233 N.C. 283, 63 S.E.2d 822 (1951), the court by dictum noted that a manufacturer's liability in sealed food cases was a matter of "primary liability." *Id.* at 287, 63 S.E.2d at 826.

[35] Criswell Baking Co. v. Milligan, 77 Ga. App. 861, 50 S.E.2d 136 (1948) (contaminated pie); Myer v. Greenwood, 125 Ind. App. 288, 124 N.E.2d 870 (1955) (trichinosis); Kelly v. J. R. Daily Co., 56 Mont. 63, 181 P. 326 (1919) (impure pig's feet); Alpine v. LaSalle Diners, 197 Misc. 415, 98 N.Y.S.2d 511 (1950) (wire in pie); Mahoney v. Shaker Square Beverages, 46 Ohio Op. 250, 102 N.E.2d 281 (1951) (exploding bottle); Tedder v. Coca-Cola Bottling Co., 224 S.C. 46, 77 S.E.2d 293 (1953) (glass in coke). *Contra,* Walter v. Bowman Dairy Co., 318 Ill. App. 305, 47 N.E.2d 739 (1943) (paint in milk is evidence of negligence); Gearing v. Berkson, 223 Mass. 257, 111 N.E. 785 (1916) (unwholesome pork chops is some evidence of negligence); Cheli v. Cudahy Bros. Co., 267 Mich. 690, 255 N.W. 414 (1934) (trichinosis is no evidence of negligence).

[36] N.C. GEN. STAT. §§ 106-120 to -145 (1960). The presence of a substance "natural" to the food is not an adulteration. Adams v. Great Atl. & Pac. Tea Co., 251 N.C. 565, 112 S.E.2d 92 (1960) (crystallized corn in corn flakes).

[37] In Ward v. Morehead Sea Food Co., 171 N.C. 33, 87 S.E. 958 (1916), the court imposed civil liability for a violation of this statute but did not resolve the question of whether such a violation was negligence *per se*. It seems that no decision since *Ward* has considered this question. However, the court has held that a violation of a safety statute having force as law is

The most effective remedy for an injured consumer and ultimate user is usually an action against the manufacturer on an implied warranty. Since the Code is inadequate and the court apparently refuses to alter the case law, the legislature should expressly abrogate privity to provide adequate protection to the public.[38]

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negligence *per se*. Lutz Indus. Inc. v. Dixie Home Stores, 242 N.C. 332, 88 S.E.2d 333 (1955) (North Carolina Building Code). There, the court said "it is well settled law in this jurisdiction, that when a statute imposes upon a person a specific duty for the protection of others, that a violation of such statute is negligence *per se*." *Id.* at 341, 88 S.E.2d at 339.

[38] Virginia has enacted such a statute.

> Lack of privity between plaintiff and defendant shall be no defense in any action brought against the manufacturer or seller of goods to recover damages for breach of warranty, express or implied, or for negligence, although the plaintiff did not purchase the goods from the defendant, if the plaintiff was a person whom the manufacturer or seller might reasonably have expected to use, consume, or be affected by the goods . . . .

VA. CODE ANN. § 8-654.3 (Supp. 1964). A bill that would partially abrogate the privity requirement had been introduced into the North Carolina General Assembly, H.B. 251, 1965 Sess., but was killed in committee. News and Observer, April 23, 1965, p. 12, col. 1.