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Notes and Comments

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Administrative Law—Expansion of "Public Interest" Standing

The Federal Administrative agencies, regarded by New Dealers as the most effective political instrument for social and economic reform, have long since lost their progressive aura. The quest for revitalization has been carried on in the legislature and the law reviews for a generation.[1] Meanwhile, the federal judiciary has steadily widened public access to these centers of power. Judges have expanded the procedural law of "standing to sue" to urge upon the agencies broader value considerations and an affirmative burden of inquiry ever since the Supreme Court decided the "watershed case,"[2] *FCC v. Sanders Bros. Radio Station.*[3] Development of standing is particularly evident in court review of Federal Power Commission and Federal Communications Commission proceedings,[4] for these agencies have been the most criticized by courts and commentators.[5] Two recent cases,[6] setting aside FPC and FCC orders, have significantly broadened the right of standing. In remanding the records, the Courts of Appeals for the District of Columbia and Second Circuit made explicit the relationship between the public's right to participate in and appeal from agency action and the agencies' duty to plan in the public interest.

When it established a number of new agencies during the Depression, Congress typically provided that persons "aggrieved" by administrative action could initiate review by the courts.[7] In the

[1] See Universal Camera Corp. v. NLRB, 340 U.S. 474 (1951); Jaffe, *The Effective Limits of the Administrative Process: A Reevaluation*, 67 HARV. L. REV. 1105 (1954); BERNSTEIN, REGULATING BUSINESS BY INDEPENDENT COMMISSION (1955); Friendly, *A Look at the Federal Administrative Agencies*, 60 COLUM. L. REV. 429 (1960).

[2] JAFFE, JUDICIAL CONTROL OF ADMINISTRATIVE ACTION 503 (1965) [hereinafter cited as JAFFE].

[3] FCC v. Sanders Bros. Radio Station, 309 U.S. 470 (1940).

[4] JAFFE 517.

[5] See Friendly, *The Federal Administrative Agencies: The Need for a Better Definition of Standards*, 75 HARV. L. REV. 863, 1055 (1962).

[6] Scenic Hudson Preservation Conference v. FPC, 354 F.2d 608 (2d Cir. 1965), *cert. denied*, 384 U.S. 941 (1966); Office of Communications of United Church of Christ v. FCC, 359 F.2d 994 (D.C. Cir. 1966).

[7] *E.g.*, Securities and Exchange Act § 9 (a), 48 Stat. 80 (1933), as amended 15 U.S.C. § 77i (1964); Federal Communications Act § 402(b)

absence of such statutes, the Supreme Court had not granted standing to parties who had not suffered a "legal wrong." This meant in practice that the petitioner was required to be a member of the class whose "interests" were protected by the challenged agency. For instance, in the *Chicago Junction Case*,[8] a railroad was allowed to challenge an Interstate Commerce Commission order allowing a competing railroad to control a station used by both. But in *L. Singer & Sons v. Union Pacific Ry. Co.*,[9] non-members of the transportation industry had no standing to complain of ICC action permitting an extension of trackage that favored their competitor.

The Supreme Court did not follow the traditional theory of standing when faced with a suit brought under a "person aggrieved" statute. In *FCC v. Sanders Bros. Radio Station*[10] it held that petitioner had no right to complain that it would suffer severe economic injury if the FCC licensed a competitor, because the act was not designed to protect existing licensees.[11] Yet petitioner did have standing to sue, since it was definitely "aggrieved" by the licensing order.[12] It could raise issues of law, and attempt to prove that the license grant was not in the "public interest." This was what Congress had intended by the review provision; if not, then such actions would be unreviewable and the section would be meaningless.[13]

The distinction thus drawn between the basis for standing and the issues presentable on appeal greatly increased the opportunity for review. Since access to the courts now depended only on allegation of some adverse effect suffered, judicial review would no longer be a province wholly occupied by members of the regulated industry. The concept of "interest" was now poured into a new mold:

(6), 48 Stat. 926 (1934, 47 U.S.C. § 402(b)(6) (1964); Federal Power Act § 313 (b), 49 Stat. 860 (1935), 16 U.S.C. § 825(1)(b) (1964); Food, Drug, and Cosmetic Act § 701 (f) 52 Stat. 1055 (1938), 21 U.S.C. § 371(f) (1964) ("adversely affected"); Administrative procedure Act § 10(a), 60 Stat. 237 (1964), 5 U.S.C. § 1009(a) (1964).

[8] The Chicago Junction Case, 264 U.S. 258 (1964).

[9] L. Singer and Sons v. Union Pacific Ry. Co., 311 U.S. 295 (1940). The Court said petitioners must show a greater interest than "a common concern for obedience to law," *id.* at 302. Review was allowed to a "party in interest" under the Transportation Act, 24 Stat. 379 (1887), 49 U.S.C. § 1(20) (1964).

[10] 309 U.S. 470 (1940).

[11] *Id.* at 475.

[12] *Id.* at 477.

[13] *Ibid.*

that of "private Attorney General."[14] Since "public interest" was to be the focus of the reviewing court's attention, the judges were encouraged to urge the agencies away from "industry orientation" and toward "consumer orientation."[15]

In developing the theory of standing suggested in *Sanders*, the federal courts decided that aggrievement need not be financial, and allowed consumers as well as competitors to assert their view of the "public interest." The Court of Appeals for the District of Columbia, for example, thought that radio station KOA was aggrieved by a license grant to another station, which would interfere with KOA's signal. The Supreme Court affirmed, *FCC v. NBC (KOA)*,[16] on the narrower ground that KOA's license had been modified by the order, so it was a member of a class given a specific right of review by the statute.[17] The FCC took advantage of this holding by arguing until recently that only those showing personal economic injury or electronic interference could appeal its orders. But the broad interpretation of "aggrieved" proposed in the court of appeals' opinion[18] was reasserted by the same court in *Office of Communications of United Church of Christ v. FCC*.[19] The implications that circuit had seen in *Sanders* in 1942 were fully realized in 1966, when it held that the FCC must allow "audience participation" in licensing proceedings.[20]

An opinion by Judge Frank of the second circuit was important and influential in the process. *Associated Industries v. Ickes*[21] held that a consumer's group threatened with financial loss by an order raising the fixed price of coal could challenge the order in court.

[14] Judge Frank's term in Associated Indus. v. Ickes, 134 F.2d 694 (2nd Cir. 1943), *vacated as moot*, 320 U.S. 707 (1943).

[15] See Office of Communications of United Church of Christ v. FCC, 359 F.2d 994, 1004-05 (D.C. Cir. 1966); for a theory of "industry orientation" in federal regulation agencies, see JAFFE 10-16.

[16] 319 U.S. 239 (1943), *affirming* 132 F.2d 545 (D.C. Cir. 1942).

[17] FCC v. NBC (KOA), 319 U.S. 239 (1943).

[18] It stated that non-economic injury was recognized by the term "aggrieved," since otherwise non-profit radio stations could not appeal. NBC v. FCC, 132 F.2d 545, 547 (D.C. Cir. 1942). This court subsequently allowed users of a mass transit system to protest an agency action allowing use of radio broadcasts on buses, and the Supreme Court apparently agreed on the standing question. Pollak v. Public Utilities Comm'n, 191 F.2d 450 (D.C. Cir. 1951), *rev'd on other grounds*, 343 U.S. 451 (1952).

[19] 359 F.2d 994, 1001 (1966).

[20] *Id.* at 1005.

[21] Associated Indus. v. Ickes, 134 F.2d 694 (2d Cir. 1943), *vacated as moot*, 320 U.S. 707 (1943).

In his opinion Judge Frank pointed out the revolutionary effect of *Sanders'* statement that Congress had conferred standing on parties who could not otherwise be heard. He dealt at length with the "case or controversy" requirement of the federal constitution.[22] The required controversy existed, he said, when a public officer's action was attacked as a violation of his statutory powers. Since the Attorney General had always had constitutional authority to sue the officer, the problem was not whether a case existed, but rather who could bring it to court. *Massachusetts v. Mellon*[23] disallowed federal taxpayer suits, so a private citizen could not sue a governmental officer on his own. Congress had the power to confer on him the standing of a "private Attorney General,"[24] however, and this is the meaning of the "persons aggrieved" statutes. Apparently this doctrine has been accepted by the Supreme Court, for the constitutional objections to a liberal standing policy voiced in some early cases have not been heard since.[25]

Though we may regard the constitutional question as settled, the policy questions are not. If Congress has the power to grant standing to members of the public, how far has it exercised this power? And is there any basis outside the review statutes on which the right to standing may rest? The Supreme Court cited *Associated Industries* with approval in granting standing to a shareholder of a corporation affected by an SEC order.[26] In two later cases, it again found standing despite the speculative or minimal nature of the injury.[27] But the lack of a consistent theory was evident in one case that it heard without telling why. When the Secretary of the Interior and several electric cooperatives challenged an FPC order licensing a private power dam on the Roanoke River, Justice Frankfurter, speaking for the Court, said:

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[22] U.S. CONST. Art. III, § 2.

[23] 262 U.S. 447 (1923).

[24] Associated Indus. v. Ickes, 134 F.2d 694, 704 (2d Cir. 1943). "It is within the power of Congress to confer such standing to prosecute an appeal." FCC v. Sanders Bros. Radio Station, 309 U.S. 470, 477 (1940).

[25] Compare Justice Douglas' dissents in FCC v. NBC (KOA), 319 U.S. 239, 265 (1943), and United States *ex rel.* Chapman v. FPC, 345 U.S. 153, 175 (1953).

[26] American Power & Light Co. v. SEC, 325 U.S. 385 (1945).

[27] Parker v. Fleming, 329 U.S. 531 (1947) (tenant's protest against eviction of Office of Price Administration); Oklahoma v. Civil Service Commission, 330 U.S. 127 (1947) (State required to fire employee or lose certain highway funds allowed to challenge Hatch Act).

> We hold that the petitioners have standing. Differences of view, however, preclude a single opinion of the Court as to both petitioners. It would not further clarification of this complicated specialty of federal jurisdiction, the solution of whose problems is in any event more or less determined by the specific circumstances of individual situations, to set out the divergent grounds in support of standing in these cases.[28]

Consumer standing has been approved often, in recent years, where petitioners challenged rate fixing or natural gas licensing by the FPC.[29] The interest in these cases is usually economic, but sometimes not.[30] Members of the regulated group have been able to assert non-economic injury to gain standing before the FCC.[31] An important step was taken when a competitor who was not a broadcaster was allowed to protest the manner in which a license was used.[32] However, there had been no consumer standing before the FCC prior to 1966. And although the FPC had been challenged by conservation groups before,[33] their right to standing had not been

[28] United States *ex rel.* Chapman v. FPC, 345 U.S. 153, 156 (1953). Congress had adopted a plan for development of the Roanoke River Basin. The Secretary of the Interior, who would have control over allocation of excess power produced by a Government dam, and the cooperatives, who were interested in purchasing cheap power, argued that the plan did not permit private operations within its territory. The lower court had denied standing, United States *ex rel.* Chapman v. FPC, 191 F.2d 796 (4th Cir. 1951).

[29] California v. FPC, 353 F.2d 16 (9th Cir. 1965); City of Pittsburgh v. FPC, 237 F.2d 741 (D.C. Cir. 1956); Natural Gas Pipeline Co. of America v. FPC, 253 F.2d 3 (3rd Cir. 1958), *cert. denied*, 357 U.S. 927 (1958) (gas company which passed on rate increases to customers represented their interests as a matter of ethics and good business). "Essentially, the petitioners represent the ultimate consumers of the gas." Public Serv. Comm'n. v. FPC, 257 F.2d 717, 720 (3rd Cir. 1958), *aff'd sub nom.* Atlantic Ref. Co. v. Public Serv. Comm., 360 U.S. 378 (1959).

[30] Lynchburg Gas Co. v. FPC, 336 F.2d 942 (D.C. Cir. 1964) (under new rates petitioners would have to change suppliers).

[31] Lafayette Radio Electronics Corp. v. United States, 345 F.2d 278 (2d Cir. 1965) (holder of citizen's license could challenge FCC regulation prohibiting use of license for hobby).

[32] Philco Corp. v. FCC, 257 F.2d 656 (D.C. Cir. 1958), *cert. denied*, 358 U.S. 946 (1959) (unfair advertising).

[33] National Hells Canyon Ass'n. v. FPC, 237 F.2d 777 (D.C. Cir. 1956), *cert. denied*, 353 U.S. 924 (1957); Washington Dep't. of Game v. FPC, 207 F.2d 391 (9th Cir. 1953), *cert. denied*, 347 U.S. 936 (1954). The right of associations to represent their members has long been recognized, and was specifically approved in National Motor Freight Traffic Ass'n. v. United States, 372 U.S. 246 (1963)) (*per curiam*).

made explicit or effective until *Scenic Hudson Preservation Conference v. FPC*.[34]

One month before deciding *United Church of Christ*, the District of Columbia Court of Appeals heard a musicians' organization claim standing to represent the public's interest in live music programs, and to represent musicians aggrieved by a radio station's failure to present a promised amount of such programming.[35] Though the issue was "well briefed" and presented "interesting and intriguing questions,"[36] it was not decided. The court may have thought *United Church of Christ* presented a more clear-cut case for audience standing. Petitioners were religious and civil-rights groups claiming that television station WLBT in Jackson, Mississippi, unfairly discriminated against Negroes and Catholics in its programs, and carried excessive commercials. The FCC had heard complaints about WLBT before,[37] but had continued to renew the station's license, an action in keeping with the agency's traditional reluctance to criticize program content.[38] Faced with these circumstances, the court found that a grant of standing was "essential to insure that the holders of broadcasting licenses be responsive to the needs of the audience. . . ."[39] It said "the concept of standing is a practical and functional one,"[40] and has not remained static.

Similarly, in *Scenic Hudson* the court criticized the FPC's "narrow view" of standing.[41] That case involved Consolidated Edison's application to build a hydroelectric plant at Storm King Moun-

[34] 354 F.2d 608 (2d Cir. 1965). The FPC argued that parties must show "personal economic injury resulting from the Commission's action" in order to obtain review. *Id.* at 615.

[35] American Federation of Musicians v. FCC, 356 F.2d 827 (D.C. Cir. 1966).

[36] *Id.* at 830. The case was decided on other grounds.

[37] Office of Communications of United Church of Christ v. FCC, 359 F.2d 994, 998 (D.C. Cir. 1966); Note, 77 HARV. L. REV. 701, 710 (1964).

[38] Note, 77 HARV. L. REV. 701 (1964); Note, 68 YALE L.J. 783 (1959).

> Private-TV, because it receives huge public grants from the nation in the form of licenses, should have a large dedication to the public service. But it has never paid more than lip service to the concept and the Federal Communications Commission has never made any sustained effort to force a shift in programming—for various reasons, the most important being the influence of the TV lobby in Congress.

Markel, *A Program for Public-TV*, N.Y. Times, March 12, 1967, § 6 (Magazine), Part 1, 25, 126.

[39] 359 F.2d at 1002.

[40] *Ibid.*

[41] Scenic Hudson Preservation Conference v. FPC, 354 F.2d 608, 615 (1965).

tain in New York, "an area of unique beauty and historical significance." The complaining petitioners were an association composed of several non-profit conservation groups, and three municipalities in the area. They charged that the Commission had failed to give adequate consideration to non-economic values in its proceedings. The court discussed the congressional mandate for agency fostering of these interests, and said:

> In order to insure that the Federal Power Commission will adequately protect the public interest in the aesthetic, conservational, and recreational aspects of power development, those who by their activities and conduct have exhibited a special interest in such areas, must be held to be "aggrieved" parties. . . .[42]

Both courts rejected the objections that the Commissions could adequately represent the public interest, and that a broadening of standing would encourage participation by so many parties that proceedings would be unworkable.[43] The District of Columbia court thought that FCC representation of the listener's interest was "no longer a valid assumption."[44] And, the second circuit dismissed the FPC's fear that "literally thousands" would intervene and appeal by saying, "Our experience with public actions confirms the view that the expense and vexation of legal proceedings is not lightly undertaken."[45] The courts suggested that formation of groups represent-

[42] *Id.* at 616. Petitioners were said to have some economic interest, in addition, but this was not seen as an important factor. *Ibid.*

[43] The courts have decided that the right of intervention should be tested by the same standards applied to the right of appeal, so the benefits extended by the instant cases can be taken advantage of by those seeking to participate in agency proceedings. See, *e.g.*, American Communications Ass'n v. United States, 298 F.2d 648 (2d Cir. 1962); Public Serv. Comm'n v. FPC, 284 F.2d 200 (D.C. Cir. 1960); National Coal Ass'n v. FPC, 191 F.2d 462 (D.C. Cir. 1951). *But cf.* Local 282, Int'l Bhd. of Teamsters v. NLRB, 339 F.2d 795 (2d Cir. 1964); *contra,* Marine Engineers' Beneficial Ass'n v. NLRB, 202 F.2d 546 (3d Cir.), *cert denied,* 346 U.S. 819 (1953). Professor Davis thinks there should be a distinction between rules governing intervention and those controlling standing to appeal. DAVIS, ADMINISTRATIVE LAW TREATISE §§ 8.11, 22.08 (1964). The primary reason for limiting intervention is the fear that some parties seek only to delay the proceedings; but this objection would seem less forceful where the parties will not reap financial gain from delay.

[44] 359 F.2d at 1003. See 354 F.2d at 620. *Cf.* UAW v. Scofield, 382 U.S. 205 (1965); NLRB v. Local 2, United Ass'n of Journeymen, 360 F.2d 428 (2d Cir. 1966). These cases held that parties who brought or defended charges before the NLRB could intervene to assert their interest in court review of action taken by the Board.

[45] 354 F.2d at 617. The same language is found in JAFFE at 523. It has been said that the cost of taking a case of average complexity "adequately"

ing common interests would limit the number of participants.[46]

The courts clearly indicated in these two cases that their extension of standing was meant to provide *effective* participation by representatives of non-economic public interests. They criticized the agencies for not realizing the duty to affirmatively pursue the good of the public as a whole, rather than that of the regulated industry, and to carefully consider alternative proposals put forth by the parties.[47] The federal judiciary has not always been so forceful in encouraging agency planning. In early cases it was assumed that administrative bodies were vigorously reformist, and the courts left procedure to the agencies' discretion so long as private rights were given some protection.[48] With the passage of the Administrative Procedure Act,[49] however, Congress urged the courts to be more critical in examining agency action.[50] The courts continue to approve agency planning and exercise of administrative discretion when directed toward broad policies.[51] But they are more eager to remand records for further consideration where the agency has not adequately studied alternative proposals that appear prima facie to have merit.[52] If the parties do not present alternatives, the agencies

to the courts is "upwards of $5000." Gardner, *The Administrative Process,* in LEGAL INSTITUTIONS TODAY AND TOMORROW 108, 140 (Paulsen ed. 1959).

[46] 359 F.2d at 1005; 354 F.2d at 617.

[47] The Second Circuit said that the FPC's "role does not permit it to act as an umpire blandly calling balls and strikes for adversaries appearing before it . . ." 354 F.2d at 620. See 359 F.2d at 1008.

[48] See FCC v. Pottsville Broadcasting Co., 309 U.S. 134 (1940); NBC v. United States, 319 U.S. 190 (1943); FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944).

[49] 60 Stat. 237 (1946), as amended 5 U.S.C. §§ 1001-1011 (1964).

[50] See Universal Camera Corp. v. NLRB, 340 U.S. 474, 487 (1951).

[51] See Namekagen Hydro Co. v. FPC, 216 F.2d 509 (7th Cir. 1954) (approving denial of license to build dam on river with special recreational qualities); FPC v. Transcontinental Gas Pipe Line Corp., 365 U.S. 1 (1961) (approving consideration of end—use of gas and conservation of resources); Goodwill Stations, Inc. v. FCC, 325 F.2d 637 (D.C. Cir. 1963) (FCC within power in modifying "clear channel" stations after expiration of license term); FPC v. Union Elec. Co., 381 U.S. 90 (1965) (FPC has jurisdiction over dams in non-navigable streams, under Commerce power). This last case appears to adopt the view of Justice Jackson, whose dissent in FPC v. Hope Natural Gas Co., 320 U.S. 591, 628 (1944), urged more comprehensive planning in rate-fixing cases, including a consideration of conservation policies.

[52] Isbrandtsen Co. v. United States, 96 F. Supp. 883 (S.D.N.Y. 1951) (Frank, J.), *aff'd by an equally divided court sub nom.* Rederi v. Isbrandtsen Co., 342 U.S. 950 (1952); City of Pittsburgh v. FPC, 237 F.2d 741 (D.C. Cir. 1965); Michigan Consol. Gas Co. v. FPC, 283 F.2d 204 (D.C. Cir. 1960), *cert. denied,* 364 U.S. 913 (1960).

are expected to seek them.[53] In the instant cases, the courts further extended this liberal review policy. Alternatives to the hydroelectric plant on Storm King were discussed at some length by the second circuit,[54] which found that they had such merit that the FPC exhibited a "disregard of the statute" by not receiving them.[55] And the court in *United Church of Christ* mentioned several advantages to be found in refusing to license WLBT at all.[56] By devoting such attention to alternatives, the courts stressed that the public interest requires affirmative planning rather than passive acceptance of the regulated industry's point of view.[57]

As Professor Jaffe has pointed out, "the law of standing raises acute questions concerning the role of judicial review, or, more broadly, judicial control of public officers."[58] Jaffe and other critics agree that agency practice badly needs changing. They point to "industry orientation," lack of political responsibility, failure to define policies, and stagnation in case-by-case nearsightedness.[59] However, they differ on the function of the courts in bringing about reform;[60] and the judges have not developed a consistent

[53] See Great Lakes Broadcasting Co. v. FCC, 289 F.2d 754, 755 n.1 (D.C. Cir. 1960); Scenic Hudson Preservation Conference v. FPC, 354 F.2d 608, 620 (1965); Office of Communications of United Church of Christ v. FCC, 359 F.2d 994, 1009 (1966).

[54] 354 F.2d at 618-24.

[55] *Id.* at 620.

[56] 359 F.2d at 1009.

[57] "In these circumstances a pious hope on the Commission's part for better things from WLBT is not a substitute for evidence and findings." 359 F.2d at 1008. "The Commission's reviewed proceedings must include as a basic concern the preservation of natural beauty and of national historical shrines, keeping in mind that, in our affluent society, the cost of a project is only one of several factors to be considered." 354 F.2d at 624. Compare Public Serv. Comm'n. v. FPC, 257 F.2d 717 (3d Cir. 1958), *aff'd sub nom.* Atlantic Ref. Co. v. Public Serv. Comm'n, 360 U.S. 378 (1959). In that case the FPC had twice refused to grant a license to an oil producer at an unusually high rate; when the producer threatened to keep the oil out of the interstate market, the FPC capitulated. The court reversed, since there was no evidence that the high rate was in the public interest.

[58] JAFFE 459.

[59] See, *e.g.*, BERNSTEIN, REGULATING BUSINESS BY INDEPENDENT COMMISSION 291-95 (1955) [hereinafter cited as BERNSTEIN]; JAFFE 10-25; Friendly, *The Federal Administrative Agencies: The Need for Better Definition of Standards*, 75 HARV. L. REV. 863 (1962) [hereinafter cited as FRIENDLY]; Reich, *The Law of the Planned Society*, 75 YALE L.J. 1227 (1966) [hereinafter cited as REICH]; Shapiro, *The Supreme Court and Government Planning: Judicial Review and Policy Formulation*, 35 GEO. WASH. L. REV. 329 (1966) [hereinafter cited as SHAPIRO].

[60] Bernstein, Friendly and Shapiro counsel judicial restraint. BERNSTEIN

theory either.[61] The courts have been content to rely on the vague language of the review statutes in overcoming agency opposition to broader standing.[62] In the instant cases, though, are found the most explicit statements yet of the substantive reasons for procedural development: to make the agencies more responsive to the needs of the people.[63] This underlying policy would seem inherent in the democratic form of government. The right which implements that policy, therefore, should be recognized as being derived from a more fundamental source than a statute.[64] It is submitted that Congress in writing the review statutes, and the judiciary in interpreting them, have been, in effect, applying constitutional theory to the "fourth branch" of government. The checks on agency power provided by legislative limitation of duties, executive appointment of officers, and judicial review of actions, should be complemented by participation of interested parties in decision making. Perhaps the next step in the development traced in this note will be judicial recognition of a constitutional right to be heard in the administrative process, founded on the first amendment. As the late Professor Meiklejohn

96-97; FRIENDLY 1293; SHAPIRO 334-39. Jaffe also expresses caution, but argues for a "public action" open to all citizens with vigorous use of judicial discretion to limit appeals. JAFFE 523-24. Professor Davis disagrees, and would allow standing only to one "adversely affected in fact"; *quaere* whether he would extend that concept as far as the instant cases, and whether the general satisfaction he expresses for current review practice will continue. DAVIS, ADMINISTRATIVE LAW TREATISE §§ 23-01 (1958), 22.10 (Supp. 1965). Reich is most enthusiastic about instances of judicial aggressiveness. Particularly, he regards *United Church of Christ* as revolutionary, and he praises both cases noted here. REICH 1248-55.

[61] See text accompanying note 28 *supra*.

[62] 359 F.2d at 1001-02; 354 F.2d at 616. For an opinion sharply critical of efforts by the government to restrict standing, see United States v. Public Util. Comm., 151 F.2d 609 (D.C. Cir. 1945), *cert. denied*, 331 U.S. 816 (1947).

[63] The movement of the case law toward "audience participation" suggests a striking similarity to the aim of "participatory democracy" espoused by "New Left" groups:

> As a social system we seek the establishment of a democracy of individual participation, governed by two central aims: that the individual share in those social decisions determining the quality and direction of his life; that society be organized to encourage independence in men and provide the media for their common participation.

STUDENTS FOR A DEMOCRATIC SOCIETY, PORT HURON STATEMENT 7 (1964).

[64] It has been argued that the constitution guarantees the right to court review of arbitrary administrative action. Berger, *Administrative Arbitrariness and Judicial Review*, 65 COLUM. L. REV. 55 (1965).

has said, that amendment is concerned, "not with a private right, but with a public power, a governmental responsibility."[65]

HUGH B. ROGERS, JR.

Admission to the Bar—"Good Moral Character"—Constitutional Protections

Traditionally, states have been free to set up bar admission standards as rigorous or as lenient as desired.[1] Thus, it is permissible to require that the applicant for admission have graduated from law school,[2] that he swear to uphold state and federal constitutions[3], and that he does not advocate violent overthrow of the government.[4] Perhaps the most important requirement established by every state is that the applicant have "good moral character."[5] This requirement allows the states a great deal of discretion in determining who will be admitted to the bar since the function of this requirement is to insure that only those who have sufficiently high moral character are allowed to practice law.[6] Any determination of character is clearly a discretionary determination.[7] Since the state impliedly warrants

[65] Meiklejohn, *The First Amendment is an Absolute*, 1961 SUP. CT. REV. 245.

[1] See Note, 106 U. PA. L. REV. 753, 755 (1958).

[2] *E.g., Ex parte* Florida State Bar Ass'n, 148 Fla. 725, 5 So. 2d 1 (1941).

[3] *In re* Summers, 325 U.S. 561 (1945).

[4] Konigsberg v. State Bar, 353 U.S. 252 (1957) (by implication). All fifty states require the applicant to show nonadvocacy of violent overthrow of the government. See RULES FOR ADMISSION TO THE BAR (West 38th ed. 1963).

[5] See RULES FOR ADMISSION TO THE BAR (West 38th ed. 1963); 64 A.L.R.2d 301 (1959); Jackson, *Character Requirements for Admission to the Bar*, 20 FORDHAM L. REV. 305 (1951). Besides use of the term "good moral character," courts draw analogy and support from the term "moral turpitude," *i.e.*, if there is "moral turpitude," there is a lack of "good moral character." See Bradway, *Moral Turpitude as the Criterion of Offenses that Justify Disbarment*, 24 CALIF. L. REV. 9 (1935).

[6] See Comment, 15 STAN. L. REV. 500, 511 (1963) to the effect that the high moral character required is one that would enable the attorney to decide what is "right" for professional conduct as distinguished from private conduct.

[7] As to what considerations should be taken into account in deciding this question, see Starrs, *Considerations on Determination of Good Moral Character*, 2 CATHOLIC LAW. 161 (1956). As to whether a judge or other decision maker should follow his own convictions or that of the public in determining "good moral character," see Cahn, *Authority and Responsibility*, 51 COLUM. L. REV. 838 (1951).

to its citizens that they can place their trust in the profession, this requirement allows the state to fulfill this function.[8] Further, it has been noted that while one can acquire legal learning through experience, a person admitted to the bar who has poor moral character will likely remain so.[9]

Notwithstanding the state's interest in the protection of the public, the interests of the individual applicant have been recognized. In two 1957 cases the United States Supreme Court for the first time reversed bar admission denials. In *Konigsberg v. State Bar*[10] the Court recognized the usefulness of the requirement of "good moral character" but noted that "[s]uch a vague qualification, which is easily adapted to fit personal views and predilections, can be a dangerous instrument for arbitrary and discriminatory denial of the right to practice law."[11] In the companion case of *Schware v. Board of Bar Examiners*[12] the Court held:

> A State can require high standards of qualification, such as good moral character or proficiency in its law, before it admits an applicant to the bar, but any qualification must have a rational connection with the applicant's fitness or capacity to practice law. . . . Even in applying permissible standards, officers of a State cannot exclude an applicant when there is no basis for their finding that he fails to meet these standards, or when their action is invidiously discriminatory.[13]

In *Schware*, evidence that Schware had been a member of the communist Party, had been arrested but never indicted for "suspicion of criminal syndicalism" because of his participation in the 1934 labor disputes at California shipyards, and had used aliases was not sufficient to justify a finding that Schware was unfit to practice law. And in *Konigsberg*, evidence of alleged past membership in the Communist Party, together with Konigsberg's refusal to answer questions about this, did not warrant the committee in concluding that Konigsberg was not of sufficient moral character and was disloyal to state and federal governments in light of the fact that Konigsberg repeatedly denied that he ever espoused violent over-

[8] See Comment, 15 STAN. L. REV. 500, 511 (1963).
[9] *In re* Farmer, 191 N.C. 235, 238-40, 131 S.E. 661, 663-64 (1926), citing *In re* Applicants for License, 143 N.C. 1, 55 S.E. 635 (1906).
[10] 353 U.S. 252 (1957).
[11] *Id.* at 263.
[12] 353 U.S. 232 (1957).
[13] *Id.* at 239.

throw of the government and in good faith based his refusal to answer the questions of whether he had ever been in the Party on the fifth amendment.

A recent case applied the *Schware* holding. In *Hallinan v. Committee of Bar Examiners*[14] the California Supreme Court reversed a finding of the committee below that the applicant was not of sufficient moral character to practice law. The applicant had been denied admission because of his participation in civil rights demonstrations, with subsequent convictions for unlawful assembly, disturbing the peace, trespass to obstruct dawful business, and unlawful entry.[15] The committee of examiners thought the applicant had "shown a disrespect for the law and judicial officers, which exceeds the bounds of his acknowledged right to hold and espouse, to advocate, advertise, and to participate in mass demonstrations to achieve the acceptance of any social, political or philosophical views of beliefs in a peaceful and non-violent manner."[16]

The California Supreme Court reversed because it felt a "clear analogy" existed between the facts in *Schware* and *Hallinan*. In *Schware* the applicant was arrested for, but never convicted of a violation of the Neutrality Act of 1917 which made it unlawful for a person within the United States to join or to hire others to join the army of any foreign state. The Court in *Schware* reasoned that even if Schware had violated the Neutrality Act of 1917, this would not indicate a lack of good moral character since "[m]any persons in this country actively supported the Spanish Loyalist Government . . . many idealistic young men volunteered to help causes they believed right."[17] Likewise, the court in *Hallinan* reasoned that since many legal scholars and other eminent people, as well as ideal-

[14] 55 Cal. Rptr. 228, 421 P.2d 76 (1966).

[15] The committee listed other grounds, the gist of which was that the applicant had shown a tendency "to employ against the persons and property of others unreasonable physical force and the threat thereof." *Id.* at 231, 421 P.2d at 79 n.2. The California Supreme Court examined the applicant's prior history of fist fights and concluded this was insufficient to deny admission because such acts could be classified as "adolescent behavior" and had no direct relationship to the practice of law. *Id.* at 245, 421 P.2d at 93. The court also regarded petitioner's failure to mention his participation in a will contest and conviction in England for blocking a footpath as *de minimus* "[i]n view of the extensive list of arrests which petitioner did include in his bar application. . . ." *Id.* at 247, 421 P.2d at 95.

[16] *Id.* at 231, 421 P.2d at 79 n.2.

[17] *Id.* at 238, 421 P.2d at 86, citing Schware v. Board of Bar Examiners, 353 U.S. 232, 242 (1957).

istic youth, shared the applicant's belief, it could not be said that the applicant lacked "good moral character."[18] Criminal prosecution, not exclusion from the bar, was the manner of punishment appropriate here.[19] The court felt that the applicant would not "obstruct the administration of justice or otherwise act unscrupulously in his capacity as an officer of the court."[20]

Although *Hallinan* did not involve the situation where the applicant refuses to answer committee inquiries, cases dealing with this problem have clearly shown that the applicant's protections are not based on any clearly defined right, but are the result of a balancing of interests. In the second *Konigsberg* case,[21] it was held that since Konigsberg was warned of possible exclusion if he did not answer the questions from the committee about his alleged past Communist Party membership, it did not violate the fourteenth amendment when he was excluded because of his silence since the question was material and there would be "no likelihood that deterrence of association may result. . . ."[22] The Court reached the same result in *In re Anastaplo*.[23] Analagously, the Court in a disbarment proceeding held that the due process clause was not violated when the attorney was disbarred on the basis of his refusal to answer inquiries.[24] These cases did not overrule *Schware* and the first *Konigsberg* case because neither committee drew unfavorable inferences from the silence, as had happened in the first *Konigsberg* case, but denied admission on the ground that the applicant was non-cooperative in refusing to answer questions put to him.[25]

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[18] *Id.* at 238-39, 431 P.2d at 86-87.

[19] *Id.* at 239, 421 P.2d at 87.

[20] *Id.* at 239, 421 P.2d at 87.

[21] Konigsberg v. State Bar, 366 U.S. 36 (1961).

[22] *Id.* at 52.

[23] 366 U.S. 82 (1961). Anastaplo also refused to answer questions about his alleged past membership in the Communist Party. Although there was "substantial character evidence altogether favorable to Anastaplo, there is nothing in the Federal Constitution which required the Committee to draw the curtain upon its investigation at that point." *Id.* at 95. The rationale of the court seemed to be that the applicant was best "circumstanced to supply" information about his past. *Id.* at 90. For a complete discussion of the problem of loyalty, see Brown & Fassett, *Loyalty Tests for Admission to the Bar*, 20 U. CHI. L. REV. 480 (1953).

[24] Cohen v. Hurley, 366 U.S. 117 (1961). See note 32 *infra*.

[25] But Justice Black's dissent in *Konigsberg* points out the inconsistency between the first *Konigsberg* case and the second one:

> The majority avoids the otherwise unavoidable necessity of reversing the judgment below on that ground [the test of the 1957 cases] by simply refusing to look beyond the reason given by the Commit-

Some writers maintain that these cases mean only that the Court was unwilling to find an arbitrary or discriminatory exclusion.[26] Nevertheless, the state's power to exclude because of the applicant's refusal to answer questions actually gives the state a technique of exclusion for any undisclosed reason since in any given case application of the rule is still discretionary. Take the case of two silent applicants. If the committee wanted to exclude both, it could; but if only one were excluded, then it is apparent that considerations other than just the silence of the applicant come into play. And under the 1961 cases the real reason for exclusion could not be detrmined.[27]

Others have suggested that the Court feared the unique opportunity that the legal profession presents to the Communist Party,[28] but the more sensible view is that the Court was balancing the interests of state regulation verses individual freedom.[29] To accept the argument of the applicant that he should be allowed to remain silent would in effect shift the burden of proof from the applicant to the committee which is ill-equipped to investigate the applicant's past.[30]

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tee to justify Konigsberg's rejection. In this way, the majority reaches the question as to whether the Committee can constitutionally reject Konigsberg for refusing to answer questions growing out of his conjectured past membership in the Communist Party even though it could not constitutionally reject him if he did answer those questions and his answers happened to be affirmative.

Konigsberg v. State Bar, 366 U.S. 36, 60 (1961).

[26] See Comment, 47 IOWA L. REV. 507, 513 (1962).

[27] See Note, 64 W. VA. L. REV. 70, 74 (1961).

[28] See Comment, 47 IOWA L. REV. 507, 513 (1962).

[29] Justice Harlan, speaking for the Court, said: "Whenever, in such a context, these constitutional protections are asserted against the exercise of valid governmental powers a reconciliation must be effected, and that perforce requires an appropriate weighing of the respective interests involved." Konigsberg v. State Bar, 366 U.S. 36, 51 (1961).

See Note, 15 VAND. L. REV. 634, 634-37 (1962) in which it was suggested that in such a context, that is, in the area of state investigations for a public job, or some license, or benefit, two groups of cases appear: (1) Where the question asked is justified to protect the state's interest but the answers are of so little probative value in regard to determining fitness that exclusion here is arbitrary and unreasonable, *e.g.*, Schware v. Board of Bar Examiners, 353 U.S. 252 (1957). (2) Where the question itself is so unrelated to any state interest that it is arbitrary to ask the question, *e.g.*, Bates v. Little Rock, 361 U.S. 516 (1960) (compulsory disclosure of NAACP membership lists under city occupational license tax held unconstitutional); NAACP v. Alabama *ex rel.* Patterson, 357 U.S. 449 (1958) (membership lists of NAACP not relevant to a determination of fitness to conduct intrastate business).

[30] However, it is at least questionable whether the ultimate burden of persuasion is shifted to the committee. The court in *Konigsberg* distin-

Furthermore, the Court appeared to fear that the Supreme Court would become a "super state supreme court of appeals."[31]

This balancing of interests in regard to the fifth amendment is now subject to question since the recent case of *Spevack v. Klein*[32] overruled *Cohen*. Although *Spevack* held only that the self-incrimination clause of the fifth amendment applied to state disbarment proceedings through the fourteenth amendment, disbarment is not so dissimilar from admission proceedings that *Spevack* could not be used analogously to overrule the second *Konigsberg* case and *In re Anastaplo*.[33] Furthermore, if one assumes that the state policy behind either proceeding is the same—to maintain high ethical standards in the profession for the protection of the public—it would likewise appear that the issue of whether the first and fifth amendments should apply to admission proceedings is basically the same.

guished Speiser v. Randall, 357 U.S. 513 (1958), which held that it was a violation of due process to require taxpayers to prove their nonadvocacy of violent overthrow of the government in order to receive tax exemptions, from the burden of proof required for bar admission. While in *Speiser* the taxpayer had the ultimate burden of persuasion, the applicant for bar admission had only the burden of coming forward with the evidence; thus, there was a greater threat to the individual in *Speiser* since the taxpayer would have to disclose more information than the applicant would have to give in the *Konigsberg* situation. But if this is so, only the burden of coming forward is shifted to the committee. Thus, it appears to be less of a handicap to the committee, assuming it already has the ultimate burden of persuasion.

It is also questionable whether the Court, speaking through Justice Harlan, was correct in implying that the committee has the ultimate burden of proof. Most states place the burden of proof on the applicant, See Note, 106 U. PA. L. REV. 753 n.4 (1958). Even if the applicant still has it, California Supreme Court Justice Traynor suggests that the exclusionary rule should be applied only where there is a prima facie espousal of communist theory, or for that matter any question of fact in issue. Konigsberg v. State Bar, 52 Cal. 2d 769, 774-78, 344 P.2d 777, 780-83 (1959) (dissenting opinion). This would mean that the applicant could be silent about certain matters if he has already put in evidence sufficient to rebut any prima facie case made by the committee.

But see Sprecher, *Bar Admission Agencies: Their Right to be Informed*, 51 A.B.A.J. 248 (1965).

[31] "[O]ur function here is solely one of constitutional adjudication, not to pass on what has been done as if we were another state court of review, still less to express any view upon the wisdom of the State's action." *In re* Anastaplo, 366 U.S. 82, 97 (1961). See Comment, 56 MICH. L. REV. 415, 424-25 (1958).

[32] 87 S. Ct. 625 (1967).

[33] The court in *Spevack* said: "In this context [disbarment proceedings] 'penalty' is not restricted to fine or imprisonment. It means . . . the imposition of any sanction which makes assertion of the Fifth Amendment privilege 'costly.'" *Id.* at 628. The argument would be that exclusion is as "costly" as disbarment.

The Court has had less trouble in sustaining procedural protections for the applicant. In *Willner v. Committee on Character & Fitness*[34] the applicant was denied admission on the basis of an adverse and confidential trial report from a committee of lawyers. Willner was not allowed to examine this report nor was he told of the charges it contained. The New York State Court of Appeals denied Willner's petition for a hearing on the charges. On certiorari to the United States Supreme Court, it was held: "petitioner was denied procedural due process when he was denied admission to the Bar by the Appellate Division without a hearing on the charges filed against him before either the Committee or the Appellate Division."[35] Although it might appear somewhat unclear whether a right to a hearing includes the right of confrontation and cross-examination, a recent case had no trouble in finding that this was a part of the *Willner* case.[36] State courts have also insisted that the applicant have procedural protection.[37]

Thus, except for the procedural right to a hearing, the Court has established no standards for the committees to follow. Although *Schware* established the requirement of a "rational connection," cases relying on *Schware* do not make it clear whether the reversal of the exclusion is based on a finding that the committee used a qualification that has no rational connection with the applicant's fitness or whether the committee was reversed because it excluded when there was no basis for their finding that the applicant failed to meet the standards.[38] Having no guides as to what is a "rational connection" between the question asked and the determination of whether the applicant has good moral character, committees can ask questions that have little relevance to the ultimate determination to be made. This is harmful in two ways. In the first place, such questioning can subject the applicant to invasions of purely private mat-

[34] 373 U.S. 96 (1963). *Compare* Green v. McElroy, 360 U.S. 474 (1959) *with* Cafeteria Workers v. McElroy, 367 U.S. 886 (1961).

[35] 373 U.S. at 106.

[36] Application of Levine, 97 Ariz. 88, 397 P.2d 205 (1964).

[37] See *e.g.*, Application of Burke, 87 Ariz. 336, 351 P.2d 169 (1960); Application of Kellar, 81 Nev. 240, 401 P.2d 616 (1965); *In re* Crum, 103 Ore. 296, 204 P. 948 (1922).

[38] A possible exception is Florida Bar v. Wilkes, 179 So. 2d 193 (1965). The court, relying on *Schware* in a disbarment proceeding, ruled that the mere belief in existentialist philosophy did not show that the applicant was unfit to practice law.

ters.[39] Secondly, such irrational questioning can deter freedoms of expression and association.[40] In *Hallinan*, would it be unreasonable to assume that future applicants would at least be leary of participation in civil rights demonstrations? Part of Justice Harlan's rationale in refusing to allow the applicant to use the fifth amendment was that no deterrence of association would result. But is this realistic since the applicant has spent the last few years preparing for entry into the legal profession and it is always questionable whether an appellate court will reverse the exclusion in question? Thus, the ultimate responsibility for establishing proper standards to see if the applicant has "good moral character" lies with the bar examining committee.

WALLACE C. TYSER, JR.

Antitrust Law—Horizontal Mergers—Section 7 of the Clayton Act

In *United States v. Von's Grocery Co.*,[1] the Supreme Court struck down a horizontal merger[2] as a violation of Section 7 of the Clayton Act. In March of 1960, when Von's, the third largest retail grocery chain in the Los Angeles area, purchased the sixth largest, the United States brought action charging an antitrust violation. At trial, the District Court decided that from "the evidence, it cannot be concluded that the merger in question would probably lessen competition in the metropolitan area either at the time of the mergr

[39] See Griswold v. Connecticut, 381 U.S. 479 (1965).

[40] Justice Black said in the first *Konigsberg* case: "It is also important both to society and the bar itself that lawyers be unintimidated—free to think, speak, and act as members of an Independent Bar." Konigsberg v. State Bar, 353 U.S. 252, 273 (1957). See Brown & Fassett, *Loyalty Tests for Admission to the Bar*, 20 U. CHI. L. REV. 480, 501 (1953). Another bad result is the attitude such questioning produces in the applicants. It perhaps tends to make them give only the "right" answers. *Ibid.* This is bad not only because the applicant feels he has to hide some belief, but also because it will hinder the committee from reaching conclusions based on truthful answers.

[1] 384 U.S. 270 (1966).

[2] A horizontal merger is a merger between two companies that compete directly in similar economic functions, while a vertical merger is one between companies that buy or sell the product of the other, and a conglomerate merger is between companies that have no direct relationship with each other.

or in the foreseeable future."[3] On appeal[4] the Supreme Court reversed, basing its decision predominantly on the facts that there had been a continuing decline in the number of individually owned grocery stores in the area and that chain stores had acquired an increasing share of the market.

The first statutory expression of antitrust policy by Congress was the Sherman Act of 1890,[5] enacted as an attempt to combat the trend toward monopolistic control of the economy by gigantic business trusts. Unfortunately, the Sherman Act was directed primarily at the trust device and mergers were not prohibited unless an immediate monopoly was created as a result. The statute did not refer to the possible future effects of a merger.[6] Section 7 of the Clayton Act,[7] enacted in 1914, was an attempt by Congress to remedy these deficiencies of the Sherman Act. However, Since Section 7 only prevented illegal acquisition of corporate stock to effect merger, the law could be circumnavigated by purchasing company assets rather than stock in a merger operation.[8] The 1950 Celler-Kefauver Amendment to Section 7 closed this loophole by applying the Clayton provisions to assets as well as stock. The present statute is in this form.[9]

In the decisions leading to *Von's*, most of the confusion has centered around formulating a test under which the language of Section 7, "may be substantially to lessen competition," can be applied. The first case to reach the Supreme Court after the Cellar-Kefauver amendment was *Brown Shoe Co. v. United States.*[10] That

[3] United States v. Von's Grocery Co., 233 F. Supp. 976, 985 (S.D. Cal. 1964).

[4] Appeal was taken under the Federal Expediting Act, 62 Stat. 989 (1948), 15 U.S.C. § 29 (1964).

[5] 26 Stat. 206 (1890).

[6] In invalidating a price-fixing agreement among railroads, the Supreme Court looked only at the immediate effects of the agreement. United States v. Trans-Missouri Freight Ass'n, 166 U.S. 290 (1897).

[7] 38 Stat. 730 (1914), 15 U.S.C. § 18 (1964).

[8] Arrow-Hart & Hegeman Elec. Co. v. FTC, 291 U.S. 587 (1934); FTC v. Western Meat Co., 272 U.S. 554 (1926).

[9] 64 Stat. 1125 (1950), 15 U.S.C. § 18 (1964): "No corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital *and no corporation subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets* of another corporation engaged also in commerce, where *in any line of commerce in any section of the country*, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly." (Material added by the 1950 amendment is in italics.)

[10] 370 U.S. 294 (1962).

case involved both horizontal and vertical mergers, and, although the background law concerning each type of merger was different, the court applied only one test. Mr. Chief Justice Warren rejected the idea that a mere quantitative analysis of the market share produced by the merger should be determinative of whether a violation of Section 7 existed. Rather, the majority opinion indicated that a broad economic analysis must be used in determining the anti-competitive effects of a merger.[11] The court in *Brown Shoe* also recognized that the existence of a merger trend in a given line of commerce is an important factor that may require that the merger be struck down, thus formulating the so-called incipiency doctrine.[12]

The next important case involving section 7 was *Philadelphia Nat'l Bank*.[13] While the court did not there reject the broad economic analysis used in *Brown Shoe*, it found that the bank merger produced a firm controlling an "undue percentage share of the relevant market" and resulted in a "significant increase in the concentration of firms in that market."[14] In such circumstances the degree of market control was alone large enough to create a presumption of illegality and make it unnecessary to resort to the cumbersome *Brown Shoe* test.[15] The reasoning in *Philadelphia Bank* was carried a step further in *United States v. Aluminum Co. of America*[16] and *United States v. Continental Can Co.*[17] In each of these cases the actual increase in market share by the acquiring companies was very slight,[18] unlike that in *Philadelphia Bank*. The court nevertheless struck down these mergers, noting that the industries involved were highly concentrated and that in each case the mergers involved the acquisition of a viable competitor by an industry leader.

The Supreme Court's difficulties in analyzing merger cases must

[11] *Id.* at 321-322.

[12] "Third, it is apparent that a keystone in the erection of a barrier to what Congress saw was the rising tide of economic concentration, was its provision of authority for arresting mergers at a time when the trend to a lessening of competition in a line of commerce was still in its incipiency." *Id.* at 363.

[13] United States v. Philadelphia Nat'l Bank, 374 U.S. 321 (1963).

[14] *Id.* at 363. The merger resulted in a 30 per cent share of the market by the acquiring bank and a control of 78 per cent of the market by the top four banks.

[15] *Id.* at 363-64.

[16] 377 U.S. 271 (1964).

[17] 378 U.S. 441 (1964).

[18] In the *Aluminum Co.* and *Continental Can* cases, the increase in market share was less than 3 per cent in each case; however, the resulting combined market shares were 29 per cent, 25 per cent respectively.

be attributed to the very nature of the problem itself. The statutory language is in effect a broad grant of power to the Court to decide for itself the distinction between good and bad mergers. This requires that the Court predict the effect of a merger before declaring it invalid.[19] But economics is an inexact science and even economists themselves cannot predict with certainty the future effects of a merger.[20] The cost and time of accumulating sufficient data for a proper analysis is prohibitive and, indeed, the data may even be misleading to judges and lawyers lacking the necessary understanding of economic theory. In viewing the decisions from *Brown Shoe* through *Von's*, it seems that the Court must be recognizing this fact and is trying to formulate a simple test for applying Section 7. In *Philadelphia Bank, Aluminum Co.*, and *Continental Can*, the Court in essence decided that the resulting share of the market after merger was simply too large in already concentrated industries and those mergers were invalidated largely on that basis. Even though in *Von's* the resulting market share was only seven and one-half per cent,[21] far below that in the other cases, the merger was nevertheless invalidated, primarily because of a decreasing number of small competitiors in the same line of commerce.[22]

This attitude of the Court toward the individually-owned business suggests that something more than a desire for a "simple" Section 7 test underlines the *Von's* decision. From the history of antitrust litigation has emerged the idea that a system of small competitors is somehow inherently desirable.[23] This proposition has not

[19] This point was virtually sidestepped by the majority in *Von's*. See Mr. Justice Stewart's dissent: "The Court has substituted bare conjecture for the statutory standard of a reasonable probability that competition may be lessened." 384 U.S. 270 at 286.

[20] Bok, *Section 7 of the Clayton Act and the Merging of Law and Economics*, 74 HARV. L. REV. 226, 228 (1960).

[21] Before the merger, Von's had 4.7 per cent of the sales of the relevant market while Shopping Bag Food Stores, the acquired company, had 4.2 per cent of the total sales. The sales of the largest firm comprised 8 per cent of the market.

[22] What we have . . . is simply the case of two already powerful companies merging in a way which makes them even more powerful than they were before. If ever such a merger would not violate § 7, certainly it does when it takes place in a market characterized by a long and continuous trend toward fewer and fewer owner-competitors. . . . United States v. Von's Grocery Co., 384 U.S. 270, 277-78 (1966).

[23] See Judge Learned Hand's view of antitrust laws in *United States v. Aluminum Co. of America*, 148 F.2d 416 (2d Cir. 1945): "Throughout the history of these statutes it has been constantly assumed that one of their

gone unquestioned.[24] Indeed, the very nature of the grocery store business demonstrates a fallacy in this idea. Supermarket chains certainly compete more among themselves than do small corner grocery stores sprinkled across a city, and the larger stores usually offer a better selection of products, often at lower prices. It surely must be asked whether the small competitor should be protected if circumstances have already made it difficult for him to compete,[25] especially when the interests of the consumer and the industrious, expansion-minded store owner may suffer.

At any rate, the present test for legality of mergers under Section 7 is vague.[26] The businessman is not given any ascertainable standard when considering a merger. In fact, as Mr. Justice Stewart remarked, "The sole consistency that I can find is that in litigation under Section 7, the Government always wins."[27] Granted that this statement is very close to the truth, it is still difficult to say that the Supreme Court was wrong in *Von's*. A merger, once allowed, is a permanent condition, and it is better to stop a trend toward oligopoly too soon than too late. Although the *Von's* merger apparently did not injure competition, the door would have been open for similar mergers if this one had been allowed. The trend toward concentration had to be stopped at some point, and the Court cannot be seriously castigated for acting when it did.

D. J. JONES, JR.

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purposes was to perpetuate and preserve, for its own sake and in spite of possible cost, an organization of industry in small units which can effectively compete with each other." *Id.* at 429.

[24] Rill, *The Trend Toward Social Competition Under Section 7 of the Clayton Act*, 54 GEO. L.J. 891 (1966). The author questions the wisdom of prohibiting mergers which increase efficiency and competition.

[25] It is not as difficult for small stores in Los Angeles to compete with the larger ones as the majority opinion in *Von's* would lead one to believe. In some cases the large, retailer-owned cooperative buying organizations in the area "were able to offer even lower prices to their members than competing chains could obtain." United States v. Von's Grocery Co., 384 U.S. 270, 299, n. 32 (1966) (Stewart, J., dissenting).

[26] Handler, *Some Misadventures in Antitrust Policymaking*, 76 YALE L.J. 92, 108-109 (1966).

[27] United States v. Von's Grocery Co., 384 U.S. 270, 301 (1966) (Stewart, J., dissenting). In the past eleven years the Justice Department has won forty-five of fifty antitrust cases before the Supreme Court. The Federal Trade Commission has not lost a single antitrust case before the Court in seven years.

Appellate Review—Prospective Overruling— Charitable Immunities

In *Rabon v. Rowan Memorial Hosp., Inc.*,[1] the North Carolina Supreme Court overruled its prior decisions[2] and held that public hospitals[3] may no longer rely on the common law tort immunity doctrine. In so doing the court announced that the decision would have no retroactive effect but would apply only to the case before it and to causes of action arising after the filing date of the opinion. The decision in part reflects an increasing awareness of the courts in recognizing the hardships that can result from retroactivity.

It is the common law tradition that a judicial decision overruling an established precedent has retroactive as well as prospective effect.[4] However, when courts strictly adhered to this theory, problems arose in relation to parties who had based their conduct on the prior decisions. As a result many courts adopted exceptions to the general rule of retroactivity. The most common exceptions involved criminal cases[5] or cases where contract[6] or property rights[7]

[1] Rabon v. Rowan Memorial Hosp., Inc., 269 N.C. 1, 152 S.E.2d 485 (1967).

[2] *E.g.*, Williams v. Randolph Hosp. Inc., 237 N.C. 387, 75 S.E.2d 303 (1953); Smith v. Duke Univ., 219 N.C. 628, 14 S.E.2d 643 (1941); Johnson v. City Hosp. Co., 196 N.C. 610, 146 S.E. 573 (1929).

[3] The court otherwise professes to maintain charitable immunity as applied to "churches, orphanages, rescue missions, transient homes for the indigent, and other similar institutions which remain charitable institutions in fact."

[4] Mr. Justice Holmes in 1910 wrote "I know of no authority in this court to say that in general state decisions shall make law only for the future. Judicial decisions have had retrospective operation for near a thousand years." Kuhn v. Fairmont Coal Co., 215 U.S. 349, 372 (1910) (Dissenting opinion). See generally, Currier, *Time and Change In Judge-Made Law: Prospective Overruling*, 51 VA. L. REV. 201 (1965) [hereinafter cited as Currier].

[5] *E.g.*, State v. O'Neil, 47 Iowa 513, 126 N.W. 454 (1910); State v. Jones, 44 N.M. 623, 107 P.2d 324 (1940). *But see*, Warring v. Colpoys, 122 F.2d 642 (D.C. Cir. 1941) (writ of *Habeas corpus* denied even though construction of statute under which accused was convicted had been altered by a later decision). See generally, Freeman, *The Protection Afforded Against the Retroactive Operation of an Overruling Decision*, 18 COLUM. L. REV. 230 (1918); Snyder, *Retrospective Operation of Overruling Decisions*, 35 ILL. L. REV. 121 (1941); Note, 60 HARV. L. REV. 437 (1947).

[6] *E.g.*, Gelpcke v. City of Dubuque, 68 U.S. (1 Wall.) 175 (1863); World Fire & Marine Ins. Co. v. Tapp, 279 Ky. 423, 130 S.W.2d 848 (1939); Payne v. City of Covington, 276 Ky. 380, 123 S.W.2d 1045 (1938); Gentzler v. Smith, 320 Mich. 394, 31 N.W.2d 668 (1948).

[7] *E.g.*, Jones v. Woodstock Iron Co., 95 Ala. 551, 10 So. 635 (1892);

had been acquired in reliance on court construction of statutes or constitutions.

North Carolina was an early advocate of these exceptions. In 1904 the supreme court in *State v. Bell*[8] held that its earlier decision interpreting a criminal statute should be changed, but that the defendant could not be convicted for conduct which would not have been criminal under the prior interpretation. The court stated:

> While it is true that no man has a vested right in a decision of the Court, it is equally well settled that where, in the construction of a contract or in declaring the law respecting its validity, the Court thereafter reverses its decision, contractual rights acquired by virtue of the law as declared in the first opinion will not be disturbed.[9]

Two years later, in a case involving the question of whether a lease executed by a corporation was *ultra vires* or not, the court applied the decision prospectively since the parties had relied on a prior interpretation of a statute by the court.[10] The court cited *Bell* with approval stating that it was the only "fair and proper course to pursue" and that the "opposite ruling would have met with strong condemnation, as being contrary to the plainest principles of justice."[11] The following year the court continued this reasoning to apply prospective overruling where a common law precedent was involved.[12] However, in 1908 the court attempted to restrict the broad language of the prior decisions. In *Mason v. Nelson Cotton Co.*[13] it stated that the only exception to retroactive application should be where construction of a constitution or statute was involved. It felt it should not be extended to an "erroneous decision on general mercantile law which is contrary to accepted doctrine and recognized business methods."[14]

Hanks v. McDanell, 307 Ky. 243, 210 S.W.2d 784 (1948); Haskett v. Maxey 134 Ind. 182, 33 N.E. 358 (1893). *But cf.*, Carter Oil Co. v. Weil, 209 Ark. 653, 192 S.W.2d 215 (1946) (decision on which buyer of land relied invalidated reservations in deeds; prospective overruling would have been unfair to seller, who conveyed thinking mineral rights had been reserved).

[8] 136 N.C. 674, 49 S.E. 163 (1904).

[9] *Id.* at 677, 49 S.E. at 164.

[10] Hill v. Railroad, 143 N.C. 539, 55 S.E. 854 (1906).

[11] *Id.* at 578, 55 S.E. at 868.

[12] Hill v. Brown, 144 N.C. 117, 56 S.E. 693 (1907). However, the case involved property rights.

[13] 148 N.C. 492, 62 S.E. 625 (1908). See generally, Spruill, *The Effect of an Overruling Decision*, 18 N.C.L. REV. 199 (1939-40).

[14] *Id.* at 511, 62 S.E. at 632. Other North Carolina cases that have

Courts that have felt the need to apply a decision prospectively have generally advanced 2 reasons: (1) a justifiable reliance by the defendant on the prior law and (2) an undue hardship resulting from such reliance.[15] Although these same two reasons can be advanced in decisions involving common law interpretations as easily as in statutory construction, few courts have prospectively overruled common law decisions.[16] The doctrine as a whole received a great impetus from Mr. Justice Cardozo speaking for the United States Supreme Court in *Great N. Ry. v. Sunburst Oil & Ref. Co.*[17] Although the case involved the interpretation of a statute and the prospective overruling of a prior interpretation, Cardozo made it clear that it did not matter whether the decision involved common law or statutory construction.[18]

However, most cases after *Sunburst* that applied a decision prospectively still involved contract, property or criminal law.[19] In the field of tort law the rule continued to be one of retroactive application of decisions.[20] Recently common law doctrines of sovereign and charitable immunity have been vigorously attacked resulting in numerous decisions discarding the previous announced rule.[21] The Illinois Supreme Court in *Molitor v. Kaneland Community Unit*

applied a decision prospectively have also involved contract, property or criminal law. *e.g.*, Wilkinson v. Wallace, 192 N.C. 156, 134 S.E. 401 (1926); Fowle v. Ham, 176 N.C. 12, 96 S.E. 639 (1918). However, after this flurry of cases at the beginning of the century, the court has failed to apply the doctrine in any recent cases. See generally, Note, 11 N.C.L. REV. 323 (1932-33); Note, 5 N.C.L. REV. 170 (1927).

[15] See cases cited notes 4-6 *supra.*

[16] *E.g.*, Jones v. Woodstock Iron Co., 95 Ala. 551, 10 So. 635 (1892); World Fire & Marine Ins. Co. v. Tapp, 279 Ky. 423, 130 S.W.2d 1045 (1938). Writers have criticized the courts for making this distinction. See *e.g.*, Freeman *The Protection Afforded Against the Retroactive Operation of an Overruling Decision*, 18 COLUM. L. REV. 230 (1918).

[17] 287 U.S. 358 (1932).

[18] Cardozo also made it clear that prospective operation did not conflict with the due process clause of the fourteenth amendment. He stated that a state could decide for itself between prospective or retroactive operation. 287 U.S. at 364.

[19] For an extensive list of citations see Note, 60 HARV. L. REV. 437, 441-47 (1947).

[20] Tort cases that have applied a decision prospectively have involved changes in rules of procedure. *E.g.*, Dempsey v. Thompson, 363 Mo. 339, 251 S.W.2d 42 (1952) (instructions on damages in personal injury suit). See generally, Currier at 244 for the reasoning behind the absence of prospectiveness in tort cases.

[21] The court in *Rabon* lists all the jurisdictions. See 269 N.C. at 17-19, 152 S.E.2d at 496-98.

Dist. No. 302,[22] therefore, felt this situation clearly called for an application of prospective overruling. The reliance factor was clear. School districts relying on the immunity had for years failed to purchase any liability insurance and if the decision were applied retroactively, the result would have been unjust. In *Rabon* the North Carolina Supreme Court specifically recognized this injustice and prospectively overruled the immunity of charitable hospitals.[23]

However, the court in *Rabon* took another step that seems to stand on more tenuous ground. Since *Sunburst* was wholly prospective, many critics claimed this left the plaintiff unrewarded and was little incentive for others to commence actions to change existing, outmoded laws.[24] As a result, the court in *Molitor* announced that the new rule of liability would extend not only to all cases arising after the lling date of the opinion but also allowed the plaintiff in that case to recover. The North Carolina Supreme Court followed this position.

This practice produces results which are not easily justified. First of all reliance is the main argument the courts have used to justify applying decisions prospectively and clearly the defendant before the court has relied on the rule as much as anybody. Moreover, there seems little justification for rewarding this plaintiff because he is before the court and failing to allow numerous other injured parties to recover—especially where their suits have been commenced before this one.[25]

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[22] 18 Ill. 2d 11, 163 N.E.2d 89 (1959), *cert. denied*, 362 U.S. 968 (1960).

[23] Although reliance is generally advanced for applying a decision prospectively, Professor Currier suggests that in the immunity field the courts might not have reached this result without a concern for maintaining institutional stability. Currier at 245. Other jurisdictions have refused to apply their decision discarding immunity prospectively, specifically rejectng the reliance theory. See *e.g.*, Haney v. City of Lexington, 386 S.W.2d 738 (Ky. 1964) (Soverign immunity); Dauton v. St. Luke's Catholic Church, 27 N.J. 22, 141 A.2d 273 (1958) (charitable immunity).

[24] For an extensive listing of law review articles on *Sunburst* see Note, 13 MONT. L. REV. 74, 78 n.15 (1952). The other criticism generally advanced against *Sunburst* is that to announce a new rule to be followed in the future and not apply it to the case before the court would amount to mere dictum. See generally, Note, 14 VAND. L. REV. 406 (1960).

[25] See generally Keeton, *Creative Continuity In the Law of Torts*, 75 HARV. L. REV. 463 (1962). This led to the ironical result in *Molitor* that the other seventeen children injured in the same accident were denied recovery in the lower court. Although this was reversed on appeal because of the procedure followed in the original case indicating that the plaintiff was representing the other claimants, the expense of an additional appeal was necessary.

Of the other three jurisdictions which have applied the new rule to the plaintiff in the suit before them,[26] the Michigan Supreme Court has encountered the most difficulty. When the court in *Parker v. Port Huron Hosp.*[27] overturned the charitable immunity doctrine, there was a vacancy on the court reducing the normal membership from eight to seven. The court split four to three in overruling the doctrine. The following year in *Browning v. Paddock*,[28] where the plaintiff's cause of action arose prior to *Parker* and was thus theoretically barred, the court was unanimous in denying liability but the same split occurred as to the reason. Four justices applied the prospective rule of *Parker* in barring plaintiff, while three applied the common law immunity rule. Justice Black, the new member of the court, stated that if he had been on the court during *Parker* he would have voted to apply the decision prospectively. However, he felt that it should have been wholly prospective and should not have allowed the plaintiff there to recover. On the same day as *Browning* the court discarded the municipal immunity doctrine in *Williams v. City of Detroit*.[29] The lower court had denied recovery based on the common law immunity. The supreme court affirmed this but again split 4-3-1. Justice Black voted with the four to abolish soverign immunity in the future but felt it should not be applied to the instant case. His vote was therefore counted with the "three" resulting in an affirmance denying liability. The result was, in effect, a wholly prospective decision announcing abrogation of immunity for future litigants but the peculiar split left the status of soverign immunity unclear. In 1965 the Michigan Supreme Court apparently reached a compromise when it abrogated soverign immunity as applied to a state subdivision. The court announced that its decision would apply to "pending and future cases" as well as to that case itself.[30]

Thus, for courts that are reluctant to overrule outmoded decisions because of the reliance of the parties on precedent, prospective overruling is a desirable addition to the range of choices. How-

[26] Parker v. Port Huron Hosp., 361 Mich. 1, 105 N.W.2d 1 (1960); Myers v. Drozda, 180 Neb. 183, 141 N.W.2d 852 (1966); Kojis v. Doctors Hosp., 12 Wis. 2d 367, 107 N.W.2d 292 (1961).

[27] 361 Mich. 1, 105 N.W.2d 1 (1960).

[28] 364 Mich. 293, 111 N.W.2d 45 (1961).

[29] 364 Mich. 231, 111 N.W.2d 1 (1961).

[30] Myers v. Genesee County Auditor, 375 Mich. 1, 133 N.W.2d 190 (1965). Arizona also adopted this position in Stone v. Arizona Highway Comm'n, 93 Ariz. 384, 381 P.2d 107 (1963).

ever, the North Carolina Supreme Court in *Rabon* would have done well to have considered the warning enunciated by Justice Black in *Williams v. City of Detroit*:

> If we are to overrule, let us do it outright either way, manfully according to the tried rules of judicial process. That is the only way to avoid what *Browning* and *Molitor* already have proven; that an appellate court, having determined to reward one litigant only of a distinct and inseparable class of litigants, naively asks for and gets into no end of trouble.[31]

To reduce the uneven treatment resulting from partially prospective overruling, the preferable solution would have been for the court to have chosen between wholly prospective and retroactive application.[32]

JAMES A. MANNINO

Bankruptcy: Trustee's Title to Bankrupt's Property

In *Bank of Marin v. England*[1] a debtor drew five checks upon his commercial account with the defendant bank. The debtor then filed a voluntary petition in bankruptcy before the checks were presented for payment. Six days after the petition was filed, the bank, having no notice of bankruptcy proceedings, paid the checks when presented by the payee. The bankruptcy trustee sought to require the bank to pay him the amount paid by the bank upon the five checks. The referee found the bank and the payee jointly liable to the bankrupt's estate for the amount of the checks and the district court enforced this finding. The decision was affirmed by the Court of Appeals for the Ninth Circuit[2] holding that a bank that honors checks in good faith without notice of voluntary petition in bankruptcy is liable to the bankruptcy trustee for the amount paid.[2] The Supreme Court granted certiorari because of the importance of the question presented, and reversed.

In 1938 Congress passed the Chandler Act amendments to the Bankruptcy Act. These amendments were made necessary by the

[31] Williams v. City of Detroit, 364 Mich. 231, 278-79, 111 N.W.2d 1, 14 (1961) (Concurring opinion).

[32] See generally Keeton, *Creative Continuity In the Law of Torts*, 75 HARV. L. REV. 463 (1962).

[1] 385 U.S. 99 (1966).

[2] 352 F.2d 186 (9th Cir. 1965).

many uncertainties surrounding the judicial interpretations of the language of the Bankruptcy Act of 1898.[3] The Chandler Act provided in section 70(a)[4] that title would vest in the trustee in bankruptcy by operation of law as of the date the petition in bankruptcy is filed. This section was necessary to effectuate the well settled objectives of federal bankruptcy legislation of protecting the rights of creditors and facilitating the speedy and efficient distribution and settlement of the estate.[5] The Chandler Act also added section 70(d),[6] which enumerates transfers whose validity will be upheld if they take place after petition and before adjudication or before a receiver takes possession of the bankrupt's property. Section 70(d)[7] protects the transferee of personal property from the bankrupt if the transfer was made in "good faith"[8] and for "present fair equivalent value."[9] The only provision exempting transactions occurring after adjudication is section 21(g),[10] which allows real property to be freely transferred, but only real estate located in the same county or equivalent district as the bankrupt.

Section 70(d)(2)[11] provides that a person indebted to the bankrupt can pay the indebtedness of the bankrupt without liability to the trustee provided he acts in good faith and before adjudication of

[3] Bankruptcy Act, ch. 541, § 70(a), 30 Stat. 565 (1898). See WEINSTEIN, THE BANKRUPTCY LAW of 1938, 161 (1938); McLaughlin, *Amendment of the Bankruptcy Act*, 40 HARV. L. REV. 583 (1927).

[4] 52 Stat. 879 (1938), as amended, 11 U.S.C. § 110(a) (1964).

[5] 4 COLLIER, BANKRUPTCY, ¶ 70.01, at 926 (14th ed. 1964). See Simonson v. Granguist, 369 U.S. 38, 40 (1962); Kuehner v. Irving Trust Co., 299 U.S. 445, 452 (1937).

[6] 52 Stat. 881 (1938), 11 U.S.C. § 110(d) (1964).

[7] 52 Stat. 881 (1938), 11 U.S.C. § 110(d)(1) (1964) reads in part:

> A transfer of any of the property of the bankrupt, other than real estate, made to a person acting in good faith shall be valid against the trustee if made for a present fair equivalent value or, if not made for a fair equivalent value, then to the extent of the present consideration actually paid therefor, for which amount the transferee shall have a lien upon the property so transferred. . . .

[8] Bankruptcy Act § 70(d)(3), 52 Stat. 881 (1938), 11 U.S.C. (d)(3) (1964) reads in part:

> "A person having actual knowledge of such pending bankruptcy shall be deemed not to act in good faith unless he has reasonable cause to believe that the petition in bankruptcy is not well founded. . . ."

[9] *In re* Richter, 40 F. Supp. 758 (S.D. N.Y. 1941) (Satisfaction of old debts not present value even though transferees extended new credit); Lehman v. Quigley, 118 N.Y.S.2d 579 (Sup. Ct. 1952) (satisfaction of court judgment on antecedent course of action is not a concurrence of a "present fair equivalent value").

[10] 52 Stat. 852 (1938), 11 U.S.C. § 44(g) (1964).

[11] 52 Stat. 881 (1938), 11 U.S.C. § 110(d)(2) (1964).

bankruptcy. Under this section the bank would be protected if it had honored the check after the filing of an involuntary petition but before the adjudication of bankruptcy.[12] However, section 18(f)[13] of the Bankruptcy Act provides that the filing of a voluntary petition constitutes automatic adjudication and thereby renders section 70(d) inapplicable. Thus in the case before us, since this was in effect a post adjudication transfer, the bank would not be protected by section 70(d)(1) or 70(d)(2).

The only other provision in section 70(d) that the bank could have asserted as a defense is the negotiability proviso of 70(d)(5).[14] But since the filing of a voluntary petition constitutes adjudication under section 18(f) it appears that bank payments subsequent to filing must be invalid. In *Rosenthal v. Guaranty Bank & Trust Co.*[15] the court, basing its decision on the negotiability proviso, upheld the validity of a good faith payment by a bank of a bankrupt's checks after adjudication. However, this case has been generally criticized[16] on the grounds that presentation of a check to the drawee bank for payment is not a negotiation. Thus it appears the negotiability proviso should not protect the drawee bank in the *Marin* situation.[17]

Therefore, it appears that a bank paying a check in good faith without notice that the drawer has filed a voluntary petition in bankruptcy will find no protection under section 70(d). The court of appeals recognized the inequities of the situation but concluded that it could not exercise its equitable powers because of section 70(d)'s invalidation of post adjudication transfers.[18] The decision in the lower court put banks in the impossible position of keeping constantly informed of every bankruptcy proceeding involving their

[12] Feldman v. Capitol Piece Dye Works, Inc., 293 F.2d 889 (2d Cir. 1961); Citizens' Union National Bank v. Johnson, 286 Fed. 527 (6th Cir. 1923).

[13] 52 Stat. 851 (1938), 11 U.S.C. § 41(f) (1964).

[14] 52 Stat. 882 (1938), 11 U.S.C. § 110(d)(5) (1964) which reads in part: "Provided, however, that nothing in this title shall impair the negotiability of currency or negotiable instruments."

[15] 139 F. Supp. 730 (W.D. La. 1956).

[16] See 70 HARV. L. REV. 548 (1957).

[17] The negotiability proviso is for the protection of the holder in due course who receives payment prior to adjudication. Here the holder is allowed to retain the proceeds and if payment is refused he can share in the bankrupt's estate as an unsecured creditor. 70 HARV. L. REV. 548, 550 (1957).

[18] Bank of Marin v. England, 352 F.2d 186, 191 (9th Cir. 1965).

depositors in every federal court in the country. In addition, the bank would be under the conflicting duty to honor checks drawn on its depositors.[19]

The Supreme Court, conceding that this transfer is not protected by section 70(d), circumvented sections 70(a) and 18(f) by basing their decision on the due process requirement of notice, and overriding equitable considerations. The Court's first contention is that the bankruptcy of a drawer does not, without more, revoke the drawee's authority.[20] The Court holds that notice, "reasonably calculated, under all the circumstances, to apprise the interested parties of the pendency of the action" is required before one can be deprived of his property.[21] Therefore, the Court was unwilling to say that the mere filing of a voluntary petition was sufficient to put the bank on notice. In the present Bankruptcy Act there are but limited provisions for the giving of notice to the public of the bankruptcy proceeding. Under section 58(d)[22] all notice to creditors is at the discretion of the court, and creditors may not be entitled to personal notice since bankruptcy proceedings are considered actions in rem.[23] However, in *Mullane v. Central Hanover Bank & Trust Co.*[24] the Supreme Court held that personal notice to holders of trust interests involved in the adjudication was necessary to meet due process requirements. The *Mullane* decision, although not in a bankruptcy setting, states that the difference between in rem and in personam proceedings does not exist when dealing with the due process rights of notice and opportunity to be heard. The Court in *Marin*, in adopting the *Mullane* view, rejects the formalistic concept of an in rem proceeding by notice to the world and requires reasonable notice to the bank before liability will be imposed. The Court does not indicate what will constitute reasonable notice. It would seem that notice by publication is the least that will be required and certainly this will not impose an onerous burden on the trustee since he can easily ascertain where the bankrupt's funds are being held.

The Court also refuses to read sections 70(d)(5) and 18(f)

[19] UNIFORM COMMERCIAL CODE § 3-506.
[20] Bank of Marin v. England, 385 U.S. 99, 102 (1966).
[21] *Id.*
[22] 52 Stat. 867 (1938), 11 U.S.C. § 94(d) (1964).
[23] Hanover Nat'l Bank v. Moyes, 186 U.S. 181, 192 (1902).
[24] 339 U.S. 306 (1950).

"with the ease of a computer"[25] and invokes the equitable power under section 2(a)[26] of the act to reach an equitable result. It is clear that a bankruptcy court is a court of equity and may exercise these equitable powers in granting or withholding relief in its administration the bankrupt's estate.[27] However, these equitable powers may only be exercised where the result produced will not be inconsistent with the Bankruptcy Act.[28] Sections 70(d) and 18(f) clearly indicate the Congressional intention to invalidate post adjudication transfers.[29] It is also clear that the payment of funds after adjudication frustrates one of the main objectives of the Bankruptcy Act—preserving the estate for the benefit of creditors. However, even if it is concluded that equitable relief, in the form of validation of the transfer, is foreclosed by the act, an equitable result may still be achieved and the estate preserved by simply adjusting the liabilities as between the bank and the creditor. This is, in effect, what the Court did. They preserved sections 70(d) and 18(f) "by imposing liability on the payee of the checks as if he has received a voidable preference or other voidable transfer."[30]

Aside from the inherent in equities in holding the bank liable in this situation there are other compelling reasons for making the trustee go only against the payee creditor. If the transaction with the bankrupt constituted a voidable preference under section 60(a)-(b)[31] of the act then multiple litigation may be avoided by suing the payee first. This would be true in most cases because the subsequent presentment of the check to the bank should be sufficient evidence of bad faith to allow the drawee bank to be indemnified for the money paid out.[32] Therefore in this situation, by suing the payee first there will be no need for an indemnity suit.

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[25] Bank of Marin v. England, 385 U.S. 99, 102 (1966).

[26] 52 Stat. 842 (1938), 11 U.S.C. § 11(a), reads in part:

". . . courts of bankruptcy are hereby invested . . . with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction. . . ."

[27] Pepper v. Litton, 308 U.S. 295, 304 (1939).

[28] Securities Comm'n v. U.S. Realty Co., 310 U.S. 434, 455 (1939); Pepper v. Litton, 308 U.S. 295 (1939).

[29] 4 COLLIER, BANKRUPTCY ¶ 70.67, at 1500 (14th ed. 1964).

[30] Bank of Marin v. England, 385 U.S. 99, 103 (1966).

[31] 52 Stat. 869 (1938), as amended, 11 U.S.C. 96(a)-(b) (1964): A voidable preference is a payment of an antecedent debt within four months of bankruptcy with reasonable cause to believe the debtor is insolvent.

[32] Farmers & Merchants Bank v. Universal C.I.T. Credit Corp., 4 Utah 2d 155, 160-61, 289 P.2d 1045, 1049 (1955).

If the transfer were not a voidable transfer or if joint liability were imposed there are still several ways to adjust the liability. It does not seem that the liability should depend on whether payment was in the form of check or cash. If this were payment of an antecedent debt by cash it would not be a valid transfer since such a payment is not for "present fair equivalent value."[33] If joint liability were imposed in this situation the payee creditor would be in a better position than the bankrupt's other creditors. If the bank pays first and has no right of indemnity against the creditor, then the creditor, to the extent of the bank's contribution, will be favored over the other creditors. On the other hand, the bank's loss would be total unless by subrogation it were allowed to participate in the distribution of the bankrupt's estate. The right of subrogation here would depend on whether this transaction was viewed as if the bank, by paying the judgment, had paid the creditor's claim and thus stood in his position as an unsecured creditor.[34] But if the creditor were to pay the entire judgment, he would still be able to share in the bankrupt's estate as an unsecured creditor.

The Court in *Marin* adopted the simplest and most equitable solution in this situation by limiting the trustee to an action against the payee. This would result in the payee bearing the entire loss resulting from distribution by the bankrupt estate. In a situation, as here, where the bank has had no notice of the bankruptcy proceeding this is simply a restoration to the status quo.

FRANCIS X. HANLON

Constitutional Law—Is the Restricted Cross-Examination Rule Embodied in the Fifth Amendment?

In the historic Supreme Court decision of *Malloy v. Hogan*[1] it was established that the fifth amendment guarantee of freedom from self-incrimination is imposed on the states by way of the fourteenth amendment.[2] The recent case of *Spevak v. Klein*[3] emphasized the scope of this determination by holding that no group or classifica-

[33] See note 9 *supra*.
[34] See, 40 MINN. L. REV. 499 (1956).

[1] 378 U.S. 1 (1964). See notes in 43 N.C.L. REV. 9 (1964); 73 YALE L.J. 1491 (1964).
[2] U.S. CONST. amend. V provides in part that no person "shall be compelled in any criminal case to be a witness against himself. . . ." For ex-

tion of people is without its purview.[4] But an additional problem area remains that may have a significant impact on North Carolina procedure. This is concerned with the rules governing the scope of cross-examination as they affect the criminal defendant who chooses to testify.

North Carolina adheres to the "wide-open"[5] rule of cross-examination. This procedure dictates that the criminal defendant waives his immunity from self-incrimination by the mere act of taking the stand.[6] As a consequence he is subjected to cross-examination on any matter relevant to the issues being tried.[7] The federal courts, however, follow a restrictive rule[8] whereby the defendant technically waives the privilege by testifying in his own behalf, but can be cross-examined only on matters brought out on direct.[9] It is uncertain whether this rule is based on procedural[10] or constitutional[11] con-

amples of other constitutional protections that have been imposed on the states in recent years see *e.g.*, Pointer v. Texas, 380 U.S. 400 (1965) (sixth amendment guarantee of the right of confrontation); Gideon v. Wainwright, 372 U.S. 335 (1963) (sixth amendment right to counsel); Mapp v. Ohio, 367 U.S. 643 (1961) (fourth amendment bar of illegally seized evidence).

[3] 87 Sup. Ct. 625 (1967).

[4] *Id.* at 628.

[5] The "wide-open" rule is so designated because it does not confine the scope of inquiry to matters testified to on direct. See McCORMICK, EVIDENCE §§ 21, 26, 131 (1954).

[6] This is established by N.C. GEN. STAT. § 8-54 (1953), which provides in part:

> In the trial of all indictments, complaints, or other proceedings against persons charged with the commission of crimes . . . the person so charged is, at his request, but not otherwise, a competent witness, and his failure to make such request shall not create any presumption against him. But every such person examined as a witness shall be subject to cross-examination as other witnesses.

[7] State v. Dickerson, 189 N.C. 327, 127 S.E. 256 (1925). See STANSBURY, NORTH CAROLINA EVIDENCE §§ 56-57 (2d ed. 1963).

[8] For discussion of the federal approach see Orfield, *Examination of Witnesses in Federal Criminal Cases*, 4 ARIZ. L. REV. 215 (1963); Orfield, *The Privilege Against Self-Incrimination in Federal Cases*, 25 U. PITT. L. REV. 503, 547 (1964); 5 U. CHI. L. REV. 116 (1937); 36 U. DET. L.J. 162 (1958).

[9] Fitzpatrick v. United States, 178 U.S. 304 (1900); United States v. Pate, 357 F.2d 911 (7th Cir. 1966); Simon v. United States, 123 F.2d 80 (4th Cir. 1941); Madden v. United States, 20 F.2d 289 (9th Cir.), *cert. denied*, 275 U.S. 554 (1927); Tucker v. United States, 5 F.2d 818 (8th Cir. 1925). See also McCORMICK, EVIDENCE § 26 (1954).

[10] Some cases merely state that the defendant becomes subject to cross-examination to the same degree as any other witness. This, of course, means the restrictive rule. See *e.g.*, Fitzpatrick v. United States, 178 U.S. 304 (1900).

[11] The Eighth Circuit Court of Appeals in Tucker v. United States, 5

cepts, but if the Supreme Court should determine that it is a necessary appendage to the fifth amendment protection, the North Carolina practice would become unconstitutional.[12]

In exploring such a possibility, two considerations may prove controlling. The Court in recent years has not hesitated to expand the number of individual protections available to criminal defendants in state court proceedings.[13] Moreover, particular attention has been paid to alleviating conditions surrounding the assertion of constitutional privileges that tend to undermine the strength of the right guaranteed. For example, the Court reasoned in *Escobedo v. Illinois*[14] that guaranteeing a criminal defendant the right to counsel at the trial stage alone is insufficient when the possibility exists that a pre-trial confession rendered when the accused did not have benefit of counsel may negate any advantage of courtroom representation.[15] Applying this rationale to the protection of the self-incrimination privilege, cross-examination procedures of the North Carolina variety[16] in which a defendant who takes the stand "is subject to the same treatment as other witnesses,"[17] become suspect. The privilege has little value for an accused who deems it expedient to testify but can ill afford broad cross-examination. It is submitted that the existence of such an inherent restraint may lead the Court to consider the "wide-open" rule an unwarranted threat to the exercise of the privilege.

A second consideration is evidenced by the *Malloy* concern for

F.2d 818 (8th Cir. 1925), accorded the rule constitutional sanction. The court determined that when the defendant was questioned concerning matters not brought out on direct testimony, he was "compelled . . . over seasonable and proper objection to be a witness against himself, in violation of the Fifth Amendment to the Constitution." *Id.* at 824. For examples of both prior and subsequent cases that make no mention of Constitutional implications in the rule see *e.g.*, Fitzpatrick v. United States, 178 U.S. 304 (1900); United States v. Pate, 357 F.2d 911 (7th Cir. 1966).

[12] North Carolina is not the only state in which such a determination would invalidate existing practice. Arizona, for example, has recently restated its position that a criminal defendant who takes the stand to give testimony in his own behalf is "subject to cross-examination as to all matters relevant to the issues being tried." State v. Taylor, 99 Ariz. 85, 407 P.2d 59, 64 (1965). *Accord,* Shelton v. State, 397 S.W.2d 850, 851 (Tex. Crim. App. 1965).

[13] See note 2 *supra.*

[14] 378 U.S. 478 (1964). See 43 N.C.L. REV. 187 (1964).

[15] 378 U.S. at 486.

[16] See STANSBURY, NORTH CAROLINA EVIDENCE § 108 (2d ed. 1963).

[17] *Id.* § 56, at 116.

variations in the implementation of constitutional protections in state and federal forums. The Court reasoned that as the first, fourth, and sixth amendment are enforced according to the same standards in both,[18] it would be incongruous to deny a criminal defendant the same uniformity of application when considering an assertion of a fifth amendment privilege.[19] It is conceded that the Court's attention was focused on claim rather than waiver of privilege, but it must be remembered that the practical effect of the federal limitation on the scope of cross-examination is to make waiver incomplete, leaving a portion of the privilege intact.[20] Thus, whether the restricted rule is considered a part of the privilege or merely a collateral result of its waiver, it is impossible to disassociate one from the other. Both are interwoven in the trial context and become a unit for consideration by an accused who must weigh the advantages of a claim of privilege in light of the consequences of waiver. As this determination may well depend on the forum because of the variance in cross-examination procedure, the Court's propensity for uniformity[21] may render the "wide-open" rule unacceptable.

W. H. FAULK, JR.

Constitutional Law—"Freedom of Association's" Inapplicability to Greek-letter Fraternities

In April of 1965 the brothers of Sigma Chi fraternity at Stanford University issued an invitation of membership to Kenny Washington, a Negro—thereby breaking with century-old traditions.[1] His admittance to the fraternity was contradictory to the "all white" heritage of Sigma Chi.[2] Shortly after Washington's pledging, the national fraternity suspended the Stanford chapter[3]—the first of a

[18] 378 U.S. at 10.
[19] *Id.* at 11.
[20] United States v. Pate, 357 F.2d 911 (7th Cir. 1966).
[21] See notes 19 & 20 *supra* and accompanying text.

[1] Sigma Chi was founded at Miami University, Oxford, Ohio, in 1855. 13 ENCYCLOPEDIA AMERICANA 402 (1948).
[2] A few weeks after Washington's "pledging," the national president of Sigma Chi predicted that no Negro would ever become a member of the fraternity. N.Y. Times, June 19, 1965, § 1, p. 14.
[3] The national executive committee of the fraternity stated that the suspension of the chapter had nothing to do with any membership question.

series of encounters destined to lead eventually to the severance of all relations between the local chapter and the parent body.[4] In Washington's home city of Denver, newspaper reports of the Stanford upheaval attracted the attention of a member of the Board of Regents of the University of Colorado. He suggested to the Board that Sigma Chi's action in regard to its Stanford chapter indicated that the fraternity was actively violating a resolution adopted by the Regents in 1956, whereby fraternities practicing racial or religious discrimination at Colorado were to be placed on probation. The Regents subsequently ordered the Beta Mu (Colorado) chapter of Sigma Chi to produce evidence to the contrary. Officers of Beta Mu appeared at a hearing, but chose to remain silent. On the basis of the only evidence available—chiefly letters written by the chief executive officer of the national fraternity and others directly concerned with the Stanford incident—the Regents concluded that chapters of Sigma Chi were compelled to practice racial discrimination. Beta Mu was placed on probation, including loss of rushing and pledging privileges, until such time as it complied with the 1956 resolution. Following an unsuccessful attempt by Beta Mu to have the Regents lift the probation, the fraternity brought an action seeking injunctive relief from the penalty, plus a declaratory judgment that the Regents had exceeded their authority and that their actions were unconstitutional and void. In *Sigma Chi Fraternity v. Regents of the University of Colorado*,[5] a three-judge district court denied relief, holding that the Regents acted within the scope of their authority and that there was no violation of the fraternity's constitutional rights of freedom of association or procedural due process.

The fraternity's argument was grounded primarily in allegations that enforcement of the 1956 resolution resulted in an unconstitutional abridgment of the group's right of "freedom of association." This right has received judicial recognition chiefly in *NAACP v. Alabama*.[6] In that case, the U.S. Supreme Court held that the

According to a statement issued by the national president, the suspension was based upon the chapter's "contemptousness for the fraternity and its ritual." Blackwell, *How Civil Rights Act Affects Fraternities,* COLLEGE AND UNIV. BUS. 53 (Dec. 1966).

[4] *Id.* at 54. The final disaffiliation was the result of a unanimous vote of the chapter members.

[5] 258 F. Supp. 515 (D. Colo. 1966).

[6] 357 U.S. 449 (1958).

state's insistence that the NAACP disclose its membership lists constituted interference with "freedom to engage in association for the advancement of beliefs and ideas"—a freedom which the court equated with freedom of speech and assembly. Sigma Chi argued that freedom of association as described in *NAACP v. Alabama* should be extended to fraternities, and that Colorado protected no significant state interest by regulating its membership policies. Prior to its consideration of the right of association issue, the court found that the Regents' resolution constituted "state action"—a finding vital to two separate determinations in the case. First, it was necessary to describe the resolution as a "statute" in order to invoke the jurisdiction of a three-judge Federal panel under 28 U.S.C. § 2281.[7] Second, it was necessary to describe the Regents as having sufficient authority to assert the state's interest. To reach these conclusions, the court here relied primarily on a statutory provision that "The Board of Regents shall have the general supervision of the university, and the exclusive control and direction of all funds and appropriations to the university."[8]

Having reached the essential constitutional question, the court asserted that "the right of association is not . . . an absolute right,"[9] and reviewed a number of cases upholding the right in order to determine whether it should be extended to Sigma Chi.[10] These cited cases applied the right of association doctrine to problems of state interference with political, economic, religious, or cultural interests similar to those protected in *NAACP*. The court characterized its crucial determination as whether freedom of association *necessarily* carried with it the advancement or promotion of ideas. Could it be applied "in relation to a social organization having no broad

[7] See McWood Corp. v. State Corp. Comm'n, 237 F. Supp. 963 (D.N.M. 1965).

[8] COLO. REV. STAT. ANN. § 124-2-10 (1963).

[9] 258 F. Supp. 515, 525 (D. Colo. 1966).

[10] The court cited NAACP v. Button, 371 U.S. 415 (1963), in which a Virginia statute regulating the solicitation of legal business was held violative of freedom of association because litigation was essential to the NAACP's attempts to obtain its legal and political objectives; Aptheker v. Secretary of State, 378 U.S. 500 (1964), which couched freedom to travel in terms of associational rights; Brotherhood of Railroad Trainmen v. Virginia, 377 U.S. 1 (1964), which extended *Button* to the right of unions to "associate" for the preservation of their rights by recommending lawyers for injured members; and Elfbrandt v. Russel, 384 U.S. 11 (1966), holding that state oaths of allegiance for public employees bore no logical relationship to attempts to inhibit subversive organizations.

public interest objectives. . . . ?"[11] The three-judge panel concluded that the right of association had never been applied expressly to a social fraternity. Then, faced with the apparent necessity of either rejecting or accepting such an application, the court only skirted the issue. It turned its attention to *Webb v. State University of New York*[12] and *Waugh v. Board of Trustees*,[13] both of which upheld absolute prohibitions of fraternities by state universities as proper means to promote a state's interest in supervision and control of its educational institutions. The 1956 Colorado University resolution, it said, was aimed at this same state interest. Sigma Chi's assertions in regard to its own freedom of association were noted only in the comment that "if the right exists it is a relative one." The court took notice of two factors tending to reinforce the finding of a valid state interest: the University's positive interest in eliminating racial discrimination, and the fact that Sigma Chi's penalty appeared "mild" when compared to the absolute prohibitions allowed in *Webb* and *Waugh*.

Finally, apart from the issue of freedom of association, the court resolved the due process problem in the Regents' favor. It held that Sigma Chi's failure to avail itself of the opportunity to make a showing barred any complaint of unfairness, and that sufficient evidence was available to sustain the Regents' conclusions. Noting that Beta Mu was "in the middle" in the case, the court concluded:

> . . . we are powerless to remedy this. Our function is to consider the constitutional validity of the action taken. We have found that it is valid. The fact that the Regents could possibly have proceeded with more diplomacy or skill in solving this problem is not a matter for our consideration.[14]

It is unfortunate that the court in the present case did not assert itself with more finality in regard to the question which it raised regarding the applicability of freedom of association to organizations lacking public objectives.[15] Nevertheless, the decision is im-

[11] 258 F. Supp. 515, 525 (D. Colo. 1966).
[12] 125 F. Supp. 910 (N.D.N.Y. 1954).
[13] 237 U.S. 589 (1915).
[14] 258 F. Supp. 515, 529 (D. Colo. 1966).
[15] "It is important to note that the NAACP cases arose in contexts of interference with such interests as political, economic, religious, or cultural interests, *although it does not appear that the right of association is neces-*

portant. The court strongly implies, despite averments to the contrary, that the right should be applied only to protect political or philosophical interests like those in *NAACP*. This implication reflects the balancing performed by the court, and its decision that the university's interest—here, the eradication of racial discrimination—outweighs the fraternity's right to select members free of state regulation. Extension of freedom of association to Sigma Chi would have had the effect of using the doctrine to *further* public racial discrimination, in complete opposition to its application in *NAACP*. Thus, although *Sigma Chi* appears to add little substantive law to the holdings in the *Waugh*[16] and *Webb*[17] cases cited by the court, it does apply certain elements of the right of association doctrine to the previously untouched problem of fraternity racial discrimination.[18]

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sary limited to such objectives." 258 F. Supp. 515, 525 (D. Colo. 1966) (emphasis added).

[16] 237 U.S. 589 (1915). In upholding a legislative prohibition of all fraternities at state schools, the court said at p. 596-597: "It is to be remembered that the University was established by the state, and is under the control of the state, and the enactment of the statute may have been induced by the opinion that membership in the prohibited societies divided the attention of the students, and distracted from that singleness of purpose which the state desired to exist in its public educational institutions."

[17] 125 F. Supp. 910 (N.D.N.Y. 1954).

[18] The problem has had widespread impact in recent years, although the instant case reflects the only reported litigation. Sigma Chi alone has had several chapters involved in controversies, and five have left the fraternity in recent years. News Release, Stanford University News Service, Nov. 10, 1966. President Barnaby Keeny of Brown University (himself a member of Sigma Chi) ordered the chapter there to sever all ties with the national because of the presence of a "social acceptability" clause in the fraternity's constitution. N.Y. Times, Oct. 26, 1965, p. 28. The clause which he found offensive to the University's principles states:

> Every chapter owes a duty to every other chapter, to the whole fraternity and to any man considered for membership, for as long as it continues to hold a charter in Sigma Chi, to refrain from proposing for membership to our fellowship *any person who for any reason is likely to be considered personally unacceptable as a brother by any chapter or any member anywhere.*

Constitution of Sigma Chi Fraternity, Art. VIII, § 1. (Rev. 1965) (emphasis added).

With the exception of this "mutually acceptable" clause, Sigma Chi retains no patent restrictions on chapter membership policies as of this writing. The official pledge-initiation report on every pledge filed with the national fraternity by local chapters contains no references to race and does not require that a picture be attached.

The impact of the discrimination problem is clearly not limited to the official reactions of college or fraternity officials. Some important social attitudes seem to be changing as well. Former congressman Brooks Hays,

Several aspects of the general problem of fraternity discrimination were left unexplored by in *Sigma Chi*. One authority has argued that a state acts in violation of the Fourteenth Amendment when it gives official recognition at state universities to fraternities with discriminatory membership policies.[19] Similar views are reflected in Congressional debates concerning the possibility that federal funds be withheld from otherwise qualified institutions where such fraternities exist. Although the statutory language is subject to differing conclusions,[20] at least one high-ranking federal authority has interpreted federal law as authorizing such withholding of funds.[21] Whatever the actual intent of the current statutory provisions, numerous educational institutions have invoked them as the impetus for regulations similar to the 1956 resolution of the Colorado Regents.[22] It would appear that the most significant impact of

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a member of Sigma Chi, told the National Interfraternity Conference in 1965:

> For us to lag in moving toward this goal [racial equality in fraternities] is to leave the undergraduate confused about the American dream of equality of opportunity. We do not want the Greek letter fraternity, which is an integral part of the American educational system, to fall behind. . . . Surely it is apparent that the quiet but profound social revolution now taking place has penetrated college life. We cannot afford to close our eyes and ears to it.

A recent report of the pledging of a Negro student at Davidson College, Davidson, N.C. by Sigma Chi is demonstrative of the substantial changes now being wrought within traditional fraternity precepts. No action has been taken in the matter by the national fraternity. See The Charlotte Observer, Feb. 17, 1967, p. 1.

[19] Horowitz, *Discriminatory Fraternities at State Universities—A Violation of the Fourteenth Amendment?* 25 So. CAL. L. REV. 289, 295 (1952).

[20] The Higher Education Act of 1965 provides that no federal authority may be exercised over the membership or internal operations of "any fraternal organization, fraternity, sorority, private club or religious organization at an institution of higher education . . . which is financed exclusively by funds derived from private sources and whose facilities are not owned by such an institution." 79 Stat. 1270, 20 U.S.C. § 1144 (1965). The House version of this provision originally extended it to any of the listed organizations at any institution of higher education. Thus the Congressional language seems clearly to reflect an intent to provide for the possibility of federal control at publicly supported institutions. See U.S. Code Cong. & Ad. News, 89th Cong., 1st Sess., v. 2, 4141 (1965).

[21] James M. Quigley, Assistant Secretary of Health, Education and Welfare, announced in 1965 that under Title VI of the Civil Rights Act of 1964 (providing for withholding of federal grants and subsidies from recipients practicing racial discrimination), colleges would be required to furnish assurances of compliance, and that racial discrimination by a fraternity would invalidate such assurances. N.Y. Times, June 19, 1965, § 1, p. 14.

[22] When a nondiscriminatory provision was instituted at the University of North Carolina in 1965, the campus newspaper commented:

> [University officials] have voiced their concern that discriminatory

the decision in *Sigma Chi* will be similarly pragmatic. No doubt college authorities will adopt it as a lever for implementing both the letter and spirit of judicial determinations supporting racial equality in public educational institutions.[23]

H. HUGH STEVENS, JR.

Constitutional Law—Current Trends in Recidivist Statute Procedures

The United States Supreme Court recently affirmed the convictions of three Texas petitioners and in so doing upheld the constitutionality of the common law procedure in applying recidivist statutes.[1] The petitioners urged that due process was violated when it was explained to each juror on voir dire examination that the state was contending the petitioners had been convicted of similar crimes earlier, and further that they were deprived of an impartial trial and jury when the present indictment containing allegations of the prior convictions was read and evidence of the prior convictions put to the jury at trial.[2] The Court, in a 5-4 decision, held that because the jury was instructed not to consider past criminal conduct in deciding present guilt that minimum constitutional demands were met.[3]

The case should be of interest in North Carolina since it sustains the same procedure used here.[4] It should also encourage a re-exami-

clauses might be injurious to the University's position with the Federal Government because the fraternities are chartered by this institution. If this legal connection is strong enough to place the University in jeopardy under the 1964 Civil Rights Act, then the clauses clearly will have to go.

The Daily Tar Heel, Feb. 17, 1965, p. 2.

[23] See McClaurin v. Oklahoma State Regents, 339 U.S. 637 (1950); Brown v. Board of Educ., 347 U.S. 483 (1954).

[1] Spencer v. Texas, 87 Sup. Ct. 648 (1967). The three cases disposed of are reported below as Reed v. Beto, 343 F.2d 723 (5th Cir. 1965); Spencer v. Texas, 389 S.W.2d 304 (1965); Bell v. Texas, 387 S.W.2d 411 (1965).

[2] Brief for Petitioner, pp. 4-5, Spencer v. Texas, 87 Sup. Ct. 648 (1967).

[3] 87 Sup. Ct. at 653.

[4] N.C. GEN. STAT. § 15-147 (1965); State v. Lawrence, 264 N.C. 220, 141 S.E.2d 264 (1965); State v. Morgan, 263 N.C. 400, 139 S.E.2d 708 (1965); State v. Painter, 261 N.C. 332, 134 S.E.2d 638 (1964); State v. Powell, 254 N.C. 231, 118 S.E.2d 617 (1961); State v. Stone, 245 N.C. 42, 95 S.E.2d 77 (1956); State v. Miller, 237 N.C. 427, 75 S.E.2d 242 (1953); State v. Davidson, 124 N.C. 839, 32 S.E. 957 (1899).

nation of the procedure in the light of the state's policy of providing a fair trial and jury.[5]

It has long been recognized that while evidence of prior convictions is relevant and of probative value, it is so highly prejudicial that, with limited exceptions, a fair trial demands its exclusion.[6] Such evidence is generally admitted only in cases where the defendant raises the question of his own character or where defendant offered himself as a witness.[7]

The common law recidivist statutes provide an additional avenue for placing this same evidence before the jury notwithstanding its volatile nature. The justifying rationale is that the jury is, upon proper instructions, to suppress the knowledge of prior crimes in deciding the issue of guilt in the present case. This is questionable. There is much controversy among authorities as to how effectively jurors are able to accomplish this mental juxtaposition,[8] but it is safe to assume that even the most intellectually agile and impartial juror would be hard pressed by the task.[9] Because of this the majority of American jurisdictions and England have changed their procedures to conform with the *spirit* of providing an impartial jury and not with just meeting the minimum standard that will be tolerated. Twenty-seven states[10] have by statute or decision adopted some form of bifurcation procedure whereby evidence of prior crimes is withheld from the jury until the question of guilt in the present

[5] U.S. CONST. amend. VI; N.C. CONST. art I, § 13.

[6] Michelson v. United States, 335 U.S. 469 (1948); State v. Tessnear, 265 N.C. 319, 144 S.E.2d 43 (1965); State v. McLamb, 235 N.C. 251, 69 S.E.2d 537 (1952); MCCORMICK, EVIDENCE § 157 (1954); STANSBURY, NORTH CAROLINA EVIDENCE § 104 (2d ed. 1963); 1 WIGMORE, EVIDENCE § 57 (3d ed. 1940).

[7] MCCORMICK, EVIDENCE § 157 (1954); STANSBURY, NORTH CAROLINA EVIDENCE § 104 (2d ed. 1963); 1 WIGMORE, EVIDENCE §§ 192-94 (3d ed. 1940); 28 N.C.L. REV. 124 (1949).

[8] Krulewitch v. United States, 336 U.S. 440 (1949); Blumenthal v. United States, 332 U.S. 539 (1947); United States v. Banmiller, 310 F.2d 720 (3d Cir. 1962). For an extended discussion on juries, their functions, and effectiveness, see Skidmore v. Baltimore & Ohio R. Co., 167 F.2d 54 (2d Cir. 1948).

[9] The difficulty is evidenced by the fact that in *Spencer v. Texas* the majority at 554 and the minority at 660 both cited KALVEN & ZEISEL, THE AMERICAN JURY 180 (1966) as support for their respective positions.

[10] Researchers have reached different results on the exact number of states. See, 87 Sup. Ct. at 665 where 28 states are listed and North Carolina Attorney General as Amicus Curiae, pp. 7-8, Spencer v. Texas, 87 Sup. Ct. 648 (1967) where it is maintained that less than half the states have adopted new procedures. This researcher found that 27 states now apply a two-step procedure. See note 11 *infra*.

indictment is determined. Then, if the defendant is convicted, a second determination is made as to the prior convictions for sentencing purposes.[11] These procedures assure a fair trial while still permitting the state to effectuate its policy of increased sentences for habitual criminals. It is significant to note that Texas has joined the majority of states now using a bifurcation procedure since the convictions of the petitioners of *Spencer v. Texas*[12] and that the Attorney General of Texas even while urging affirmance acknowledged that there could be a "better method of proving prior crimes for the purpose of enhancing punishment. . . ."[13] The majority in *Spencer v. Texas* while upholding constitutionality also noted the inferiority of the single step procedure.[14] In his concurring opinion Justice Stewart stated that "it is clear to me that the recidivist procedures adopted in recent years by many other states . . . are far superior to those utilized in the cases now before us."[15]

The North Carolina Attorney General filed an amicus curiae brief in *Spencer v. Texas* asking the Court to uphold the common law procedure and thereby sanction the North Carolina approach.[16] The conclusion of the Attorney General's brief states:

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[11] Those states now employing a two step procedure in applying recidivist statutes are: *Alaska,* ALASKA STAT. § 12.55.060 (Supp. 1966); *Arkansas,* ARK. STAT. ANN. § 43-2328 (1964); *Colorado,* COLO. REV. STAT. ANN. § 39-13-3 (1963); *Connecticut,* Conn. Public Act. No. 588 § 5310 (1963); *Delaware,* DEL. CODE ANN., tit. 11, § 3912(b) (Supp. 1966); *Florida,* FLA. STAT. ANN. § 775.11 (1965; *Idaho,* IDAHO CODE ANN. § 19-2514 (1948); *Kansas,* KAN. STAT. ANN. § 21-107a 1964); *Louisiana,* LA. REV. STAT. ANN. § 15:529.1 (Supp. 1965); *Maryland,* MD. RULE OF PROC. 713 (1963); *Michigan,* MICH. STAT. ANN. § 28.1085 (1954); *Minnesota,* MINN. STAT. ANN. § 609.155 (1964); *Nebraska,* NEB. REV. STAT. § 29-2221 (1964); *New York,* N.Y. PENAL LAW § 1943; *New Mexico,* Johnson v. Cox, 72 N.M. 55, 380 P.2d 199 (1963); *North Dakota,* N.D. CENT. CODE § 12-06-23 (1960); *Ohio,* OHIO REV. CODE ANN. § 2961.13 (1954); *Oklahoma,* OKLA. STAT. ANN., tit. 22, § 860 (Supp. 1966); *Oregon,* ORE. REV. STAT. § 168.065 (Supp. 1963); *Pennsylvania,* PA. STAT. ANN. tit. 18, § 5108 (1963); *South Dakota,* S.D. CODE § 13.0611 (1939); *Tennessee,* TENN. CODE ANN. § 40-2801 (1955) as construed in Harrison v. State, Tenn., 394 S.W.2d 713 (1965); *Texas,* TEX. CODE OF CRIM. PROC. ANN. art. 36.01 (1966); *Utah,* UTAH CODE ANN. § 76-1-19 (1953); *Virginia,* VA. CODE ANN. § 53-296 (Supp. 1966); *Washington,* WASH. REV. CODE ANN. § 9.92.090 (1961); *West Virginia,* W. VA. CODE ANN. § 61-11-19 (1966).

[12] TEX. CODE OF CRIM. PROC. ANN. art. 36.01 (1966).

[13] Brief of Respondent, p. 9. Spencer v. Texas, 87 Sup. Ct. 648 (1967).

[14] 87 Sup. Ct. at 655, 656.

[15] *Id.* at 656.

[16] Appreciation is extended to the Office of the Attorney General of North Carolina for furnishing briefs of counsel as well as its own amicus curiae brief.

> North Carolina, therefore, asks that its procedure shall remain in force and not be disturbed. The criminals of the underworld are not stupid, and they quickly become aware of the facts that repeated acts of crime can bring more severe punishment. When a State legislature says that a prior conviction can bring about increase of punishment and a State supreme court holds that the issue as to the prior conviction can be tried at the same time as the trial of the subsequent offense, then why should the criminal be protected as to his criminal record? We suggest that the protection of law abiding citizens who go about their daily lives should weigh more heavily than the protection of the criminal.[17]

It is submitted that the force behind the current trend toward two-step trials is not to undermine the purpose of recidivist statutes nor to protect the convicted criminal from his past record nor to lessen the law abiding citizen's protection. Rather, an effort is being made to afford every defendant a fairer trial untainted by prejudicial evidence normally excluded.[18] It is to remove the means by which prosecutors under the guise of due process and statutory fulfillment circumvent established rules of evidence.[19] It is further submitted that no valid state policy should be founded upon advocation of a procedure on its face inferior to alternatives having not only the same ultimate effect but also desirable intermediate safeguards. For these reasons North Carolina should consider amending its statutes so that prosecutors are denied probative benefit derived from intro-

[17] Brief of the Attorney General of North Carolina as Amicus Curiae, p. 13, Spencer v. Texas, 87 Sup. Ct. 648 (1967).

[18] See *supra* notes 6-7 and accompanying text. *Compare*, Collins v. State, 70 Okla. Crim. 340, 106 P.2d 273 (1940) where it is held that a defendant is presumed innocent and therefore entitled to appear in court in civilian clothing rather than prison garb. Is the distinction between the state's physically dressing a defendant in prison clothing and mentally dressing him the same way with evidence of prior convictions great? *Cf.* Shultz v. State, 131 Fla. 757, 179 So. 764 (1938).

[19] The principal case is a prime example of this. There the defendant attempted to stipulate before the trial that he had been convicted earlier as the indictment alleged. The prosecutor refused to accept the stipulation and used the recidivist statute to present evidence to the jury of the defendant's criminal record. 87 Sup. Ct. at 662.

Three states by statute and case law allow the defendant to stipulate his prior record even though not providing a two step trial. See, CAL. PENAL CODE § 1025; ARIZ. RULES CRIM. PROC. 180 (1956); State v. Meyer, 258 Wis. 326, 46 N.W.2d 341 (1951). Quaere whether it is good policy to force a defendant to make the impossible choice between stipulating a false allegation in order to exclude prejudicial evidence or allowing the prejudicial evidence in order to avoid enhanced punishment under the state's recidivist statute.

duction of evidence going only to the question of sentencing.[20] To do so would effectuate the due process standards by affording an impartial jury to every defendant.

The simpliest yet most expedient bifurcation procedure is the so called Connecticut method[21] whereby the indictment contains two pages. On the first page are allegations pertaining to the present crime. On the second page are allegations of prior crimes to be used in imposing sentence. The defendant is, in the absence of the jury, read both pages to give him notice of the charges. Then the jury is read only the first page. If they return a guilty verdict then the second page is read to them and a fiinding is made as to the prior crimes. Thus, one jury and one trial is utilized in deciding both questions but the defendant is not deprived of *full* due process by having a jury decide the question of his guilt with the knowledge of prior convictions in mind.

In addition to the prejudicial aspect of the present statute, perhaps the practical desirability for amendment should be examined in light of the Supreme Court's present decision, recent decisions, and possible future holdings. The recent decisions dealing with voluntariness of confessions,[22] right to a transcript on appeal,[23] right to counsel,[24] and pre-trial publicity[25] leave no room to doubt the Court's concern for fair trial under the due process clause. In *Spencer v. Texas* this same concern is evidenced in the extensive dis-

[20] It should be noted that the North Carolina Court has construed the recidivist statute strictly. In several cases tacit recognition of the prejudicial effect of the statute has been shown where convictions of the principal crime were reversed even though the sentence imposed did not exceed that permissible for a first offender. In these cases minor procedural technicalities in applying the statute were not met. State v. Powell, 254 N.C. 231, 118 S.E.2d 617 (1961); State v. Stone, 245 N.C. 42, 95 S.E.2d 77 (1956). Also see State v. Painter, 261 N.C. 332, 134 S.E.2d 638 (1964) where in reversing the court said that it was desirable if not necessary that the warrant specify as particularly as the indictment to meet the recidivist statute standards. State v. Miller, 237 N.C. 427, 75 S.E.2d 242 (1953) where the indictment was held inadequate.

[21] State v. Ferrone, 96 Conn. 160, 113 Atl. 452 (1921). For codification see, UTAH CODE ANN. § 76-1-19 (1953).

[22] Miranda v. Arizona, 384 U.S. 436 (1966); Escobedo v. Illinois, 378 U.S. 478 (1963); Jackson v. Denno, 378 U.S. 368 (1963), where a two step procedure was required in determining the admission of a confession.

[23] Griffin v. Illinois, 351 U.S. 12 (1956).

[24] Miranda v. Arizona, 384 U.S. 436 (1966); Douglas v. California, 372 U.S. 353 (1963); Gideon v. Wainwright, 372 U.S. 335 (1963).

[25] Sheppard v. Maxwell, 384 U.S. 333 (1966); Marshall v. United States, 360 U.S. 310 (1959).

senting opinions of the Chief Justice and Justice Fortas,[26] joined by Justices Brennan and Douglas in a separate dissent.[27] Nor is there much comport for the proponent of the *Status quo* in the majority's reluctant affirmance.[28] The announcement by Justice Clark, who voted with the majority, that he intends to retire from the Court[29] further weakens the holding of *Spencer* and leaves to speculation whether his replacement would vote for or against affirming if and when the question is again presented. More importantly, two of the dissenting Justices felt that the common law procedure for applying recidivist statutes "undermined 'the very integrity of the fact finding process' "[30] and would have applied their dissents retroactively. As is noted in the North Carolina Attorney General's amicus curiae brief, to strike down the common law procedure would be to nullify North Carolina statutes and holdings.[31] To apply such a decision retroactively would also nullify convictions obtained using these procedures. Thus, it would seem prudent to consider changing the statute on these very practical grounds as well as on the policy basis discussed above.

PHILIP G. CARSON

Criminal Law and Procedure—Harmless Error

The harmless-error statutes and rules[1] now utilized by all the states and in the federal judicial system[2] are the product of judicial

[26] 87 Sup. Ct. at 656.
[27] *Id.* at 666.
[28] See notes 14 and 15 *supra* and accompanying text.
[29] Time, Mar. 10, 1967, p. 22.
[30] 87 Sup. Ct. at 666. *Compare*, Gideon v. Wainwright, 372 U.S. 335 (1965).
[31] Brief of the Attorney General of North Carolina as Amicus Curiae, p. 2, Spencer v. Texas, 87 Sup. Ct. 648 (1967).

[1] Typical of the harmless-error provisions is the California harmless-error provision which provides:

> No judgment shall be set aside, or new trial granted, in any case, on the ground of misdirection of the jury, or of the improper admission or rejection of evidence, or for any error as to any matter of pleading, or for any error as to any matter of procedure, unless, after an examination of the entire cause, including the evidence, the court shall be of the opinion that the error complained of has resulted in a miscarriage of justice.

CAL. CONST. art. VI, § 4½.

[2] 28 U.S.C. § 2111 (1965) provides:

On the hearing of any appeal or writ of certiorari in any case, the

reform early in this century. They arose from the desire to allow appellate courts to judge whether minor trial errors materially affect the outcome of a trial.[3] In effect, they provide that there may be some errors which in the setting of a particular case may be deemed harmless, thus not resulting in automatic reversal. In *Chapman v. California*,[4] the United States Supreme Court restricted state harmless-error provisions as applied to denial of rights guaranteed by the Federal Constitution. The rule announced by Mr. Justice Black for the Court states that where there is an error of state procedure or state law, the states may continue to apply their harmless-error rules.[5] However, state appellate judges may overlook federal constitutional violations only if the court is able to find that the error is "harmless beyond a reasonable doubt."[6]

Ruth Elizabeth Chapman and Thomas LeRoy Teale were convicted of a 1962 robbery-slaying. At the time of the trial, Article I, § 13 of the California Constitution provided that a defendant's failure to testify could be commented upon and could be considered by the court or jury.[7] Neither defendant testified at the trial and the prosecutor, relying on Article I, § 13, filled his argument to the jury from beginning to end with numerous references to their silence and inferences of their guilt resulting therefrom.[8] The judge also charged the jury that they could draw adverse inferences from the failure to testify.[9] After trial, but before petitioners appeal had

court shall give judgment after an examination of the record without regard to errors or defects which do not affect the substantial rights of the parties.

FED. R. CRIM. P. 52(a) provides:

Any error, defect, irregularity or variance which does not affect substantial rights shall be disregarded.

See also FED. R. CIV. P. 61.

[3] See, Kotteakos v. United States, 328 U.S. 750, 759-60 (1946).

[4] 386 U.S. 18 (1967).

[5] *Id.* at 21.

[6] *Id.* at 24.

[7] CAL. CONST. art. I, § 13 provides:

in any criminal case, whether the defendant testifies or not, his failure to explain or to deny by his testimony any evidence or facts in the case against him may be commented upon by the court and by counsel, and may be considered by the court or the jury.

[8] Excerpts of the prosecutor's argument are reproduced in the appendix of the majority opinion. 386 U.S. at 26-42.

[9] The trial judge charged the jury:

It is a constitutional right of a defendant in a criminal trial that he may not be compelled to testify. Thus, whether or not he does testify rests entirely on his own decision. As to any evidence or facts against him which the defendant can reasonably be expected to deny or ex-

been considered by the California Supreme Court, the United States Supreme Court declared in *Griffin v. California*[10] that such comment was a violation of the Fifth Amendment privilege against self incrimination.[11] When the California Supreme Court heard the appeal of Chapman,[12] the court, while admitting that petitioners had been denied a federal constitutional right by the comments on their silence, nevertheless ruled that the convictions could stand because the comments to the jury were harmless errors that did not affect the verdict.[13] Applying the new test announced in his opinion, Mr. Justice Black held that California had failed to show the error was harmless beyond a reasonable doubt and thus reversed the conviction.[14]

One question which *Chapman* presents is whether the Court has the power to declare this rule. This power seems questionable for two reasons. First, nowhere does the Court state that the California harmless-error provision is a violation of due process.[15] Also, the Court appears to acknowledge that other harmless-error formulations would be constitutionally permissible.[16] The Court simply states that the rule they announced will "provide a more workable standard."[17] Second, the Court in effect has assumed a general supervisory power over the trial of federal constitutional issues in a state court. While the Fourteenth Amendment protects individuals from invasion of fundamental rights,[18] nothing in the Fourteenth Amendment gives federal courts supervisory power in the affirma-

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plain because of facts within his knowledge, if he does not testify or if, though he does testify, he fails to deny or explain such evidence, the jury may take that failure into consideration as tending to indicate the truth of such evidence or as indicating that among the inferences that may be reasonably drawn therefrom those unfavorable to the defendant are the more probable. . . .

Id. at 19.

[10] 380 U.S. 609 (1965).

[11] *Id.* at 615. Tehan v. United States, 382 U.S. 406 (1966), determined that the law as declared in *Griffin* was applicable to all cases that were still pending on direct review at the time that *Griffin* was announced.

[12] People v. Teale, 45 Cal. Rptr. 729, 404 P.2d 209 (1965).

[13] *Id.* at 741, 404 P.2d at 220.

[14] 386 U.S. at 26.

[15] In his dissent, Mr. Justice Harlan argues that the provision does not violate due process. *Id.* at 47.

[16] *Id.* at 46. Justice Black states that Congress could make a different formulation.

[17] *Id.* at 24.

[18] See, Palko v. Connecticut, 302 U.S. 319 (1937).

tive sense of *McNabb v. United States*.[19] As Mr. Justice Cardozo had occasion to remark, a state rule of law "does not run foul of the Fourteenth Amendment because another method may seem . . . to be fairer or wiser or to give a surer promise of protection to the prisoner at bar."[20]

But assuming that the Court has this power, there remains the basic question of whether this new rule "will provide a more workable standard." In *People v. Watson*,[21] the California court, in defining its harmless-error provision, stated that reversal would be required only when "it is reasonably probable that a result more favorable to the appealing party would have been reached," and this judgment "must necessarily be based upon reasonable probabilities rather than upon mere possibilities."[22] Thus, the difference between the California "miscarriage of justice" test for harmless error and the "harmless beyond a reasonable doubt" test announced by Mr. Justice Black would seem to be largely verbalistic. However, the desirability of a uniform standard for determining whether a federal constitutional error is harmless is apparent from an examination of numerous past attempts to formulate a rule.[23] Applying this rule to all state courts will eliminate the need to determine whether each state harmless-error provision is consistent with the due process clause of the Fourteenth Amendment.

However, whether the California court is applying its rule of "miscarriage of justice" or the new rule of "harmless beyond a

[19] 318 U.S. 332 (1943). The Court held that incriminating statements elicited from defendants during unlawful detention by federal officials are inadmissible in federal courts. The Court stated that "the scope of our reviewing power over convictions brought here from the federal courts is not confined to ascertainment of Constitutional validity." *Id.* at 340.

[20] Snyder v. Massachusetts, 291 U.S. 97, 105 (1934). See also Spencer v. Texas, 385 U.S. 554 (1967) where the Court holds that the Constitution does not ordain the Supreme Court with authority as rule-making organ for promulgation of state rules of criminal procedure. *Id.* at 569.

[21] 46 Cal. 2d 818, 299 P.2d 243 (1956).

[22] *Id.* at 837, 299 P.2d at 255.

[23] See, Kotteakos v. United States, 328 U.S. 750 (1946) where the Court stated the material factors of the harmless-error rules to be the character of the proceedings, what is at stake upon its outcome, and the relation of the error asserted to casting the balance for decision on the case as a whole. *Id.* at 762. In Fahy v. Connecticut, 375 U.S. 85 (1963) the majority of five held the test of harmless error to be whether there is a reasonable possibility that the evidence complained of might have contributed to the conviction. *Id.* at 86-87. The four dissenters said the standard was a determination that exclusion of the unconstitutional evidence could not have changed the outcome of the trial. *Id.* at 95.

reasonable doubt," the same question will remain—is the application of the rule to the alleged error a reasonable one or was the rule applied arbitrarily to destroy or dilute constitutional guarantees? To answer this question, the Court, under whatever rule it promulgates, will have to look to each state court decision to see if the rule was reasonably applied. This will entail not only looking at the case in dispute but looking at previous applications of the rule.

Furthermore, it seems that the impact of the new rule is weakened by the fact that state courts can continue to apply their state harmless-error statutes to state errors.[24] That a state judge will mentally shift gears and consider one set of criteria to see if there is a miscarriage of justice and another set of criteria to see if the error is harmless beyond a reasonable doubt seems unlikely. In California, the holding in *Chapman* would probably be the same whichever criteria is used.[25]

Apart from the question of whether this new rule "will provide a more workable standard" is the question of whether a violation of *Griffin* should ever be subject to a harmless-error rule. It is conceded by the Court that there can be errors which in a particular setting may be so insignificant that they can be considered harmless.[26] Also, it is stated that there are some constitutional rights so basic to a fair trial that their infraction can never be treated as harmless error and will result in automatic reversal.[27] The majority opinion would seem to indicate that in a particular context a violation of *Griffin* could be harmless. This view seems to be in direct contravention of *Griffin* which held that "the Fifth Amendment . . . forbids either comment by the prosecution on the accused's silence or instructions by the court that such silence is evidence of guilt."[28] A more desirable result to the case is found in the concurring opinion of Justice Stewart. He holds that violation of Griffin should

[24] 386 U.S. at 21.

[25] The California court held that there was no miscarriage of justice because the proof of guilt was overwhelming. 45 Cal. Rptr. 729, 740-41, 404 P.2d 209, 220 (1965).

[26] Snyder v. Massachusetts, 291 U.S. 97 (1934) (denial of permission to accused to attend a view held harmless); Motes v. United States, 178 U.S. 458 (1900) (erroneous admission of written statement not prejudicial error).

[27] Gideon v. Wainwright, 372 U.S. 335 (1963) (right to counsel); Payne v. Arkansas, 356 U.S. 560 (1958) (coerced confession); Tumey v. Ohio, 273 U.S. 510 (1927) (impartial judge). The concurring opinion of Mr. Justice Stewart expands this list considerably. 386 U.S. at 42-45.

[28] 380 U.S. at 615.

never be treated as harmless error and should result in automatic reversal.[29] Harmless-error statutes are designed to stop reversals due to unimportant technicalities. But a violation of *Griffin* is a conscious act on the part of the prosecution or the court. To hold out the possibility that this violation could be harmless would only seem to tempt the unethical and award the ignorant.

The adoption of this harmless-error rule has thus committed the Court to a case-by-case determination of the extent to which unconstitutional comment on a defendant's failure to testify influenced the outcome of a particular trial; *i.e.*, was the comment "harmless beyond a reasonable doubt?" This substantial burden could have been avoided by placing *Griffin* violations in the category of Constitutional rights so basic that infractions can never be harmless error and will result in automatic reversal. Thus, the most that can be said at present is that *Chapman* has clouded the holding of *Griffin*, a cloud which hopefully will be dispelled in further decisions.[30]

EUGENE W. PURDOM

Federal Practice—Sovereign Immunity and Counterclaims Against the Government under the Tucker Act

A problem that has arisen time and again under the Tucker Act[1] involves the question of whether a defendant who has a claim against the Government, which claim could be the subject of an original suit under the Tucker Act, may assert it as a counterclaim in an action brought by the Government against him in a federal court. Any discussion of this problem must begin with the general proposition that the Government cannot be sued unless it has consented to be sued and then only in the manner in which it has so

[29] 386 U.S. at 45. See also O'Connor v. Ohio, 385 U.S. 92 (1966) where the Court reversed a *Griffin* violation without even mentioning harmless error.

[30] The question remains as to what other constitutional violations will be subject to the harmless-error test. In Cooper v. California, 386 U.S. 58 (1967), a companion case of *Chapman*, the Court did not reach the question of whether the harmless-error test should be applied to Fourth Amendment violations, as it ruled that the search was not a violation of the Fourth Amendment. *Id.* at 59.

[1] 24 Stat. 505 (1887).

consented.[2] The necessary consent for original suits in contract is found in the following section of the present codification of the Tucker Act:

> The district courts shall have original jurisdiction, concurrent with the Court of Claims, of . . . (2) Any other civil action or claim against the United States, not exceeding $10,000 in amount, founded . . . upon any express or implied contract with the United States. . . .[3]

The Court of Claims has exclusive jurisdiction over claims exceeding 10,000 dollars in amount.[4] Both the Court of Claims[5] and the district courts[6] have jurisdiction over counterclaims and set-offs asserted by the United States in suits against it. However, there is no provision regarding counterclaims asserted against the United States in actions commenced by it.

It is apparent that the provisions of the Federal Rules governing counterclaims offer no solution to the problem. Rule 13(a) requires the pleading as a counterclaim of any claim arising out of the same transaction or occurrence that is the subject matter of the plaintiff's claim. Rule 13(b) allows the pleading of a claim not arising out of the same transaction. The Rules further provide that a counterclaim may claim relief exceeding in amount or different in kind from that sought by the opposing party.[7] However, the liberal nature of these provisions is seriously diminished for purposes of this discussion by the protective provision of Rule 13(c): "These rules shall not be construed to enlarge beyond the limits now fixed by law the right to assert counterclaims or to claim credits against the United States or an officer or agency thereof."

One of the leading cases fixing those limits is *United States v. Nipissing Mines Co.*[8] The Government brought an action in the district court to recover taxes in excess of 80,000 dollars, and the defendant counterclaimed for a previous overpayment of 5,000 dollars. Although there was consent for an original suit on the claim of the defendant under the Tucker Act, the court held that the juris-

[2] United States v. Shaw, 309 U.S. 495 (1940).
[3] 28 U.S.C. § 1346(a)(2) (1962).
[4] 28 U.S.C. § 1491 (1964).
[5] 28 U.S.C. § 1503 (1950).
[6] 28 U.S.C. § 1346(c) (1962).
[7] FED. R. CIV. P. 13(c).
[8] 206 Fed. 431 (2d Cir. 1913).

diction could not be invoked by way of counterclaim. As construed by the court the statute was simply not broad enough to give the same court jurisdiction to render judgment when the claim was asserted in the form of a counterclaim. Another leading case is *United States v. Shaw*.[9] The United States had obtained a judgment against a contractor and, at the death of the contractor, filed a claim upon the judgment in a Michigan probate court to recover over 49,000 dollars. Under a Michigan statute allowing administrators to set off claims of the estate against creditors' claims, the administrator set up a claim against the Government for slightly more than 73,000 dollars and obtained a judgment against the Government for the difference of approximately 23,000 dollars. The United States Supreme Court held that the state court had no jurisdiction to render an affirmative judgment against the United States, although it could have allowed a set-off in an amount necessary to cancel the Government's claim in the probate court. Had this case been interpreted to stand for the proposition that a state court never has jurisdiction to render an affirmative judgment against the United States, its effect might not have been so confusing. But later language in the case indicated a more restrictive holding:

> It is not our right to extend the waiver of sovereign immunity more broadly than has been directed by Congress. We, of course, intimate no opinion as to the desirability of further changes. That is immaterial. Against the background of complete immunity we find no Congressional action modifying the immunity role in favor of cross-actions beyond the amount necessary as set-off.[10]

This language was in keeping with the holding in *Nipissing* where the court refused to allow a counterclaim even though the claim could have been asserted in the same court as an original suit. This more restrictive holding is the one accorded the *Shaw* case by some later cases in the lower federal courts.[11]

Such strict construction of the Tucker Act apparently resulted from the fact that the Act expressly grants the Court of Claims and the district courts jurisdiction over counterclaims, set-offs, and other demands by the Government in suits by individuals against the

[9] 309 U.S. 495 (1940).
[10] *Id.* at 502.
[11] See, *e.g.*, United States v. State Bridge Comm'n, 109 F. Supp. 690 (E.D. Mich. 1953); United States v. Biggs, 46 F. Supp. 8 (E.D. Ill. 1942).

Government in those courts.[12] Since no such express jurisdiction is granted in regard to counterclaims by individauls, some courts conclude that there was no intention to consent to suit against the United States by way of counterclaim.[13]

On the other hand there has been some evidence of a changing judicial attitude toward waiver of sovereign immunity. The trend had its beginnings in cases under the Federal Tort Claims Act and has been carried over into contract litigation by some courts. The leading case under the Tort Claims Act is *United States v. Yellow Cab Co.*[14] Yellow Cab was sued by its passenger for injuries resulting from a collision of one of its cabs with a United States mail truck. The company impleaded the United States and demanded contribution from the Government as a joint tortfeasor. The Court here applied a liberal construction of the statutory waiver of immunity in contrast with the stricter construction in *Nipissng* and *Shaw.* The Court held that the Government could be sued for contribution by way of interpleader and cross-claim although the Tort Claims Act by its terms referred to original suits only. The necessary consent was implied from the general purpose of the statute to allow the Government to be sued for its torts.

Subsequent to *Yellow Cab,* the United States Court of Appeals for the First Circuit decided *United States v. Silverton,*[15] a case that has become the important bridge between the tort and contract cases. In that case the Government sued for the purchase price of scrap webbing, and the defendant counterclaimed for loss due to the alleged misrepresentation of the Government's agents as to the character of the webbing. The court summarized the situation as being one in which the defendant could have asserted his claim as an original suit under the Tucker Act and reasoned that if the defendant had done so at the time the Government's action was pending,

[12] See notes 5 and 6, *supra.*

[13] See, *e.g.,* United States v. Wissahickon Tool Works, 84 F. Supp. 896 (S.D. N.Y. 1949).

[14] 340 U.S. 543 (1951). In another leading case under the Federal Tort Claims Act the Court held that the anti-assignment statute did not apply to assignments by operation of law, and that an insurance company could bring a suit in its own name against the United States under the Federal Tort Claims Act where the company had become subrogated to the rights of an insured by payment to the insured who had a claim against the United States under the Act. United States v. Aetna Cas. & Surety Co., 338 U.S. 366 (1949).

[15] 200 F.2d 824 (1st Cir. 1952).

the district court could have consolidated the two cases for trial under Federal Rule 42. The court took the view that it would amount to the "emptiest technicality" to reject jurisdiction over the counterclaim and to require the defendant to institute an original suit. The court was not unaware of the *Nipissing* case which it deemed to be out of harmony with the more liberal view as to the waiving of governmental immunity as expressed in the *Yellow Cab* case.[16]

The United States Court of Appeals for the Fourth Circuit has indicated, by dictum at least, that it would follow *Silverton*. Dismissing an appeal as premature in *Thompson v. United States*,[17] the court, in a more or less advisory opinion to the lower court, stated that it was no reason why the defendant's claim against the United States could not be asserted by way of counterclaim in the action by the Government since the claim of the defendant was such that it could have been the subject of an original suit in the district court. Subsequently the district court decided the counterclaim on its merits.[18]

Other circuit and district courts have joined in the adoption of the liberal view on the basis of either *Yellow Cab* or *Silverton*.[19] One notable exception to this trend is the Second Circuit where the strict construction was introduced by the *Nipissing* case in 1913. The courts there have at times expressed a preference for the liberal view,[20] yet they considered themselves bound by the earlier decisions.[21] These courts have adhered to this reverence for *Nipissing* and the strict view despite the fact that, since *Yellow Cab*, they operate under the liberal view in regard to the tort cases.[22]

A defendant encounters even more difficulty where his *compulsory* counterclaim against the Government exceeds 10,000 dollars. Under the Federal Rules he must plead the compulsory counter-

[16] *Id.* at 827.
[17] 250 F.2d 43 (4th Cir. 1957).
[18] Thompson v. United States, 168 F. Supp. 281 (N.D. W. Va. 1958).
[19] See, *e.g.*, United States v. Springfield, 276 F.2d 798 (5th Cir. 1960); United States v. Martin, 267 F.2d 764 (10th Cir. 1959); United States v. Buffalo Mining Co., 170 F. Supp. 727 (D. Alaska 1959); United States v. Petaschnick, 143 F. Supp. 206 (E.D. Wis. 1956).
[20] See United States v. Ameco Electronic Corp., 224 F. Supp. 783, 785 (E.D. N.Y. 1963).
[21] *Ibid.*
[22] See United States v. New York Omnibus Corp., 128 F. Supp. 86 (S.D. N.Y. 1955).

claim[23] or he will be precluded from bringing a subsequent suit on his claim.[24] Yet, even in the liberal jurisdictions, the district courts are without jurisdiction over counterclaims exceeding 10,000 dollars in amount.[25] Thus it has been suggested that the best course for the defendant is to plead the counterclaim since its dismissal for lack of jurisdiction does not operate as an adjudication on the merits.[26] But if the counterclaim were in fact compulsory, *i.e.*, arising out of the same transaction, it is probable that the issues in the principal claim and the counterclaim would be the same. If, after the dismissal of the counterclaim, the Government obtained a judgment on its principal claim, it would seem that the judgment would bar any retrial of those issues under general principles of res judicata.[27]

On the other hand, it is possible that, after dimissal of the counterclaim, the issues in the case would be determined in favor of the defendant. Apparently he would not be precluded from asserting his claim for affirmative relief in a new suit on general principles of res judicata in this situation.[28] However, the question of whether he would now be barred for failure to assert his claim as a compulsory counterclaim would clearly be presented.[29]

[23] FED. R. CIV. P. 13(a).

[24] See Pennsylvania R.R. v. Musante-Phillips, Inc., 42 F. Supp. 340, 341 (N.D. Cal. 1941).

[25] 28 U.S.C. § 1346(a)(2) (1962). This section was applied to counterclaims in United States v. Buffalo Mining Co., 170 F. Supp. 727 (D. Alaska 1959).

[26] See 25 GEO. WASH. L. REV. 315, 336 n.93 (1957).

[27] Suppose the United States sued a defendant alleging a breach of contract, and the defendant counterclaimed that the United States had committed the breach. Even if the defendant's counterclaim were dismissed for lack of jurisdiction, the defendant probably would have asserted the breach by the United States as a bar to recovery against him even though he could get no affirmative relief in the case. Thus, if after the dismissal of the counterclaim, the United States obtained a judgment the issue of its performance would have been litigated and could not be retried in a subsequent action. There are, however, two reasons why the result in this particular situation would not be very prejudicial to the defendant. First, it is quite possible, if not probable, that since the issues were resolved against him in this case, they would have been resolved against him even if he had been the plaintiff in a later suit. Secondly, there may be cases where the particular issues in the counterclaim and the principal claim are not the same so that the defendant could assert his claim in a subsequent suit.

[28] Even if the court finds that the particular issues had been litigated in the first case, so that they could not be retried in the subsequent case, the defendant (plaintiff in the second case) should be entitled to a judgment on the pleadings in the second case since these issues were resolved in his favor in the first case.

[29] Apparently the question is not resolved by Rule 41(b), (c) which pro-

The most a defendant could do to avoid this possibility of a plea in bar would be to file his original suit in the Court of Claims immediately after the dismissal of his counterclaim and hope to win the race to judgment. An equally unsatisfactory alternative was offered by the court in *United States v. Buffalo Mining Co.*[30] After dismissing the counterclaim, the court gave the defendant leave to amend by reducing his claim to less than 10,000 dollars.

It seems clear that the interest of efficient litigation requires a solution to the problem of counterclaims under the Tucker Act. That the *Silverton* decision offers only a partial solution is illustrated by the *Buffalo Mining Co.* case. Thus it appears that a desirable solution can be obtained only by an amendment to the Tucker Act. Of two possibilities that have been advanced,[31] the proposal that defendants with counterclaims in excess of 10,000 dollars be allowed to remove the entire case to the Court of Claims seems the least desirable since it apparently would create more problems than it would solve.[32] It seems that the better solution would be to amend the Act to expressly give the district courts jurisdiction over counterclaims against the United States regardless of the

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vides that dismissal of a counterclaim for lack of jurisdiction does not operate as an ajudication on the merits. It seems that this rule relates to the broad notion of res judicata and not the type of bar imposed for failure to assert a compulsory counterclaim in an earlier suit. However, an argument could be made in favor of the defendant under Rule 13(a). Under this Rule a pleading need not state a counterclaim that requires the presence of third parties of whom the court cannot acquire jurisdiction for a personal judgment. On the basis of that exception it could be argued that the intention was to except from the definition of "compulsory" any counterclaim met by jurisdictional problems. Thus a counterclaim dismissed for lack of jurisdiction under the Tucker Act should not be termed "compulsory" at all.

Another, but perhaps weaker, argument under 13(a) would be that once the defendant has included the counterclaim in his pleadings, he has complied with 13(a) which requires only the *pleading* of the counterclaim, and that it was never intended that a claim, although termed "compulsory" should be barred where it had been pleaded but dismissed for lack of jurisdiction over the subject matter.

[30] 170 F. Supp. 727 (D. Alaska 1959).

[31] See 73 HARV. L. REV. 602, 604 (1960).

[32] The threshold problem here would be jurisdictional. The Court of Claims presently has jurisdiction over suits *against* the United States. 28 U.S.C. § 1491 (1964). Therefore, the removal provision proposed would require expanding the jurisdiction of the Court of Claims to cover suits *by* the United States, at least in this specific situation. The probable result of such expansion would be an undesirable increase in the work load of that court.

amount of the counterclaim.[33] This solution would not only bring uniformity to the treatment of such counterclaims but would also serve the interest of efficient litigation by allowing all the rights and liabilities of the parties to be determined in a single suit in the district court.

JERRY M. TRAMMELL

Habeas Corpus—Waiver of Constitutional Guarantees

In *Stem v. Turner*[1] the appellant, a prisoner, appealed the denial of habeas corpus relief by a federal district court. The district judge after a thorough review of most of the records of the appellant's trial in a North Carolina state court and of his attempts at state post-conviction relief, refused to grant a plenary hearing and dismissed the writ. The district court found as to some of Stem's allegations that the findings of facts in state hearings were correct and concluded as to other allegations that the appellant had failed to exhaust his state remedy under the post-conviction statute. The Court of Appeals for the 4th Circuit interpreted a section of the North Carolina Post-Conviction Act[2] such that the appellant's state remedy had been exhausted and as a result the appellant was entitled to a plenary hearing in a federal district court.

In November of 1958, Thomas Stem was convicted in a North Carolina court of assault on a female with intent to rape and sentenced to a term of fifteen years. At his trial the two arresting police officers introduced illegally obtained evidence and testimony that was extremely prejudicial to him.[3] Stem's privately retained

[33] It appears that such a provision should allow the litigation of permissive as well as compulsory counterclaims. Where neither claim requires a long and complicated trial, apparently there would be no unreasonable delay. If a long or complicated trial be anticipated the court can always in "futherance of convenience" order separate trials. FED. R. CIV. P. 42(b).

[1] 370 F.2d 895 (4th Cir. 1966).

[2] N.C. GEN. STAT. § 15-218 (Supp. 1965).

[3] Stem was arrested without a warrant at his home. No search was made of the house at that time, but the police officers returned to the house later that afternoon to search it. Nowhere in the record did it appear that the officers had a search warrant, or that Stem had consented to the search. As a result of the search, the officers found the girl's underpants which were introduced into evidence, made certain observations they testified about at the trial, and took photographs of parts of the house. All of this illegally obtained evidence corroborated the story of the girl. 370 F.2d at 898.

counsel failed to object to the evidence and testimony even though North Carolina law renders evidence obtained by an illegal search incompetent.[4] The conviction was not appealed, but Stem did assert many times in several forums various legal improprieties that supposedly occurred in his trial.[5] All of these were denied, including attempts under the state post-conviction relief statute and under a writ of habeas corpus to state courts. At this point, the appellant sought a writ of habeas corpus from the United States District Court for the Eastern District of North Carolina which was also denied.

In seeking a writ of habeas corpus from the federal courts, Stem asserted many grounds, but the one which eventually found favor with the court of appeals was ineffectiveness of counsel amounting to a deprivation of due process under the fourteenth amendment.[6] The district judge had concluded that this issue, although formally raised in the pleadings, had not been asserted with proof to sustain it in any state court proceeding and, therefore, the appellant had failed to exhaust the remedy still available to him under the North Carolina Post-Conviction Hearing Act.[7] However, the act[8] seemingly provides to the contrary that "any claims of substantial denial of constitutional rights or of other error remediable under this arti-

[4] N.C. GEN. STAT. § 15-27 (1953). The prohibition against the use of evidence obtained as a result of an illegal search extends to "facts discovered or evidence obtained" by reason of the search. The federal court presumed that this would bar testimony concerning observations made during the search. Stem v. Turner, 370 F.2d 895, 898 (4th Cir. 1966).

[5] Stem v. Turner, 370 F.2d 895 (4th Cir. 1966) gives a history of the case.

> A *pro se* petition for certiorari to review the conviction was denied by the North Carolina Supreme Court on Nov. 21, 1961. Represented by privately retained counsel, appellant then sought, and was denied, relief under the North Carolina Post-Conviction Hearing Act (N.C. G.S. §§ 15-217 et seq.), after he was given a plenary hearing. A petition for writ of certiorari to the North Carolina Supreme Court to review that denial was denied Nov. 26, 1963, and a petition for a writ of certiorari was thereafter denied by the Supreme Court of the United States. Stem v. North Carolina, 379 U.S. 849 (1964). Next, a *pro se* petition for a writ of habeas corpus was denied by Wake County (North Carolina) Superior Court on April 15, 1965, and certiorari to the North Carolina Supreme Court denied June 2, 1965.

Id. at 896 n.2.

[6] Stem's main contention centered on the failure of his privately retained counsel to object to evidence that resulted from the illegal search. *Id.* at 900.

[7] *Id.* at 897.

[8] N.C. GEN. STAT. §§ 15-217 to -222 (Supp. 1965).

cle not raised or set forth in the original or any amendment petition shall be deemed waived."[9] Despite the literal language of the statute, the Attorney General of North Carolina argued that the state trial courts followed the practice of considering claims that were not raised or decided in previous applications. However, the court of appeals noted that the North Carolina Supreme Court had not had occasion to speak definitely on the subject and that absent a definite state adjudication to the contrary, the professed language of the statute must prevail over asserted trial court practice.[10] Since claims by Stem could no longer be heard under the Post-Conviction Hearing Act, he had exhausted his state remedies, but since Stem had not waived his constitutional claims under the federal standard, he was entitled to a plenary hearing in the federal district court to establish his claim to a writ of habeas corpus.

The development of the writ of habeas corpus in this country has been one of growing importance.[11] Due in part to currently expanding concepts of due process of law, the use of the writ to test the constitutionality of state criminal proceedings will continue to accelerate.[12] However, in order to maintain a balance between the state and federal court systems, Congress has declared that federal courts should abstain from exercising jurisdiction over state prisoners until state remedies have been exhausted.[13]

In 1963, the Supreme Court of the United States decided the fa-

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[9] N.C. GEN. STAT. § 15-218 (Supp. 1865).

[10] 370 F.2d at 897.

[11] The Judiciary Act of Feb. 5, 1867, ch. 28, § 1, 14 Stat. 385, first extended federal habeas corpus to state prisoners generally. The history and development is reviewed in detail in Fay v. Noia, 372 U.S. 391, 415 (1963).

[12] The number of habeas corpus applications filed in federal district courts by state prisoners is greatly increasing:

1941—127
1950—560
1955—660
1959—828

DIR. OF ADMIN. OFFICE OF UNITED STATES COURT, 1959 ANN. REP. 109.

1962—1115
1963—1903
1964—3531
1965—4664

DIR. OF ADMIN. OFFICE OF UNITED STATES COURT, 1965 ANN. REP. 118.

[13] 28 U.S.C. § 2254 (1964) provides that:

> the habeas corpus writ will not be granted for a state court unless it appears that the applicant has exhausted remedies available in the courts of the state. Remedies are not exhausted in state courts if the applicant has a right under the law of the state to raise by any available procedure, the question presented.

mous trilogy of *Fay v. Noia*,[14] *Townsend v. Sain*,[15] and *Sanders v. United States*,[16] which laid down certain federal standards for dealing with habeas corpus. In *Townsend v. Sain*, the court attempted to redefine the guidelines as to when a petitioner tried in a state court is entitled to an evidentiary hearing in a federal district court. The Court said:

> Where the facts are in dispute, the federal court in habeas corpus must hold an evidentiary hearing if the habeas applicant did not receive a full and fair evidentiary hearing in a state court, either at the time of the trial or in a collateral proceeding. In other words a federal evidentiary hearing is required unless the state-Court trier of fact has after a full hearing reliably found the relevant facts.[17]

The court set out six specific situations in which an evidentiary hearing would be mandatory under the test, including the case where "the merits of the factual dispute were not resolved in the state hearing."[18]

In *Fay v. Noia* the Court laid down certain federal standards relating to the problem of exhaustion and waiver of state remedies. The court held that procedural defaults incurred by the applicant during the state court proceedings would not bar federal habeas corpus relief as a failure to exhaust state court remedies, unless the state remedies were knowingly waived. The requirement of exhaustion of state court remedies was interpreted to mean those state court remedies still available to the applicant at the time an application for habeas corpus was filed in federal court. The federal habeas judge was given some discretion in denying relief to an applicant who had deliberately by-passed state court procedure and in doing so had forfeited his state court remedies. But the Supreme Court plainly stated that the forfeiture must meet the federal standards of waiver, for waiver affecting federal rights is a federal question.[19]

The *Townsend* and *Noia* decisions outline the possible results

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[14] 372 U.S. 391 (1963).
[15] 372 U.S. 293 (1963).
[16] 373 U.S. 1 (1963). See 42 N.C.L. REV. 352 (1964) for a discussion of all three cases.
[17] 372 U.S. at 312.
[18] *Id.* at 313.
[19] See Johnson v. Zerbt, 304 U.S. 458 (1938). The case gives the classic definition of waiver as an intentional relinquishment or abandonment of a known right or privilege.

when a state court prisoner seeks habeas corpus relief before a federal court:

1. If there has been a full hearing in the state court on the merits on the issue for which relief is sought in the federal court, the state court prisoner is not entitled to relief whether there has been a waiver or not.
2. If there has not been a full hearing in a state court on the merits, but the prisoner has knowingly waived his state court remedies, then the state court prisoner is not entitled to relief in the federal court.
3. If, however, there has not been a full hearing on the merits in the state court and there has been no waiver of state court remedies that meets federal standards, the prisoner is entitled to a hearing in the federal courts.

This last situation is applicable to *Stem v. Turner*.[20] Stem's claim for relief based on ineffectiveness of counsel had not been considered on the merits by a North Carolina hearing, but was barred by state procedure, a waiver that did not meet the federal standards.

In *McNeil v. North Carolina*,[21] the court of appeals overruled the same district court judge involved in the *Stem* case. The appellant was seeking habeas corpus relief due to the systematic exclusion of Negroes from his jury, and as in the *Stem* case the conflict between the federal standard of waiver and the North Carolina standard resulted in the assumption of habeas corpus jurisdiction by the federal courts. North Carolina case law holds that any objection to a jury not raised prior to the entry of the plea shall deemed waived, and the North Carolina post-conviction statutes state that any claim not raised in the original petition shall be deemed waived.[22] Since this does not meet the federal standard of waiver of a constitutional protection, the federal district court was directed to grant the requested writ.

The Supreme Court has made it clear that the doctrine of comity is not going to prevent the federal courts from using the writ of habeas corpus to protect the federal rights of state prisoners. Fed-

[20] 370 F.2d at 895.
[21] 368 F.2d 313 (4th Cir. 1966).
[22] See, *e.g.*, State v. Lowry, 263 N.C. 536, 139 S.E.2d 870 (1965); State v. Wilson, 262 N.C. 419, 137 S.E.2d 109 (1964): State v. Inman, 260 N.C. 311, 132 S.E.2d 613 (1963); State v. Covington, 258 N.C. 495, 128 S.E.2d 822 (1962).

eral standards are to be applied in such areas as waiver, and state procedural defaults will not bar later applications for federal habeas corpus relief. There was much criticism of the Court from various sources for these decisions. Justices Clark and Harlan wrote vigorous dissenting opinions to *Fay v. Noia*, attacking the new federal standards as abrupt departures from the Constitution and past decisions.[23] There was a fear that the delicate balance between state and federal courts would be destroyed,[24] and that the federal courts would be swamped with habeas corpus applications having an adverse effect upon the disposition of meritorious applications.[25]

In *Case v. Nebraska*[26] the court attempted to answer some of its critics by placing responsibility on the states to adopt broad post-conviction relief statutes in order to minimize the necessity of state prisoners resorting to federal habeas corpus. Justice Brennan in a concurring opinion stated that:

> Our federal system entrusts the states with primary responsibility for the administration of their criminal laws. The Fourteenth Amendment and Supremacy clause make requirements of fair and just procedures an integral part of those laws, and state procedures should ideally include adequate administration of these guarantees as well. If, by effective corrective processes, the States assumed this burden, the exhaustion requirement of 28 U.S.C. § 2254 (1958 ed.) would clearly promote state primacy in the implementation of these guarantees. Of greater importance, it would assure not only that meritorious claims would generally be vindicated without any need for federal courts intervention, but that nonmeritorious claims would be fully ventilated, making easier the task of the federal judge if the state prisoner pursued his cause further . . . . Greater finality would inevitably attach to state court determinations of federal constitutional questions, because further evidentiary hearings on federal habeas corpus would, if conditions of *Townsend v. Sain* were met, prove unnecessay.[27]

The Supreme Court has clearly put the states on notice that the maintenance of the balance between state and federal court systems

[23] 372 U.S. at 445 (Clark, J., dissenting).
[24] See, *e.g.*, Desmond, *Federal and State Habeas Corpus*, 49 A.B.A.J. 1166 (1963).
[25] 372 U.S. at 445 (Clark, J., dissenting).
[26] 381 U.S. 336 (1965) (per curiam with Clark, J. and Brennan, J. concurring in separate opinions).
[27] *Id.* at 345 (Brennan, J., concurring).

is now in the hands of the states. The growing protections that the Court's interpretation of the Constitution affords to state prisoners demands that the states reform their systems in order to comply with the federal standards. If the state systems are not reformed in such areas as right to counsel, discrimination in jury selection and use of coerced confessions there will be a continued friction between federal and state courts and an increasing flood of applications for federal habeas corpus.[28]

Justice Clark in his concurring opinion in *Case v. Nebraska*, cited North Carolina as one of the seven states to lead in providing modern post-conviction relief procedure for testing federal claims in the state courts.[29] But North Carolina has failed to go far enough in complying with federal standards.

The Supreme Court has indicated "that at some point in the criminal process, a convicted person will get a full evidentiary hearing on the merits of every federal right he asserts" and "if the prisoner has had no adequate hearing in the state court he will surely get one in the federal courts."[30] Justice Brennan in *Case v. Nebraska*[31] suggested certain desirable attributes that a state post-conviction procedure should have. He felt that "it should be sufficiently comprehensive to embrace all federal constitutional claims" and "in light of *Fay v. Noia* it should eschew rigid and technical doctrines

[28] Dean Griswold of Harvard Law School in an address, "The States and Criminal Law," given on May 13, 1965, to the Cleveland Bar Association, said:

> For, after all, the basic responsibility for the enforcement of the criminal law remains in the States. The States are, or should be, as much concerned with high standards as is the Federal government. The States should, in my view, welcome the determinations of the Supreme Court that the high standards prescribed by our Federal Constitution are to be taken seriously and should be enforced. What is needed now is for the States to accept this responsibility and to adopt means to carry it out. With proper explanation and understanding, this can, I believe, be done without impairing our enforcement of the criminal law. When the States do fully meet this responsibility, we will all be better off, and we will more nearly have realized the potentialities of our Great Federal Form of Government.

Case v. Nebraska, 381 U.S. 336, 344 n.7 (1965). See, *e.g.*, Brennan, *Some Aspects of Federalism*, 39 N.Y.U.L. REV. 945, 957-59 (1964).

[29] 381 U.S. at 340.

[30] Meador, *Accommodating State Criminal Procedure and Federal Post-conviction Reviews*, 50 A.B.A.J. 928, 929 (1964). See White v. Swenson, 261 F. Supp. 42 (W.D. Mo. 1966).

[31] 381 U.S. 336 (1965).

of forfeiture, waiver, or default."[32] Professor Meador of the University of Virginia Law School has stated:

> The federal habeas corpus judge will not now be foreclosed by a state procedural waiver. The federal judge will examine the alleged waiver himself and will give it effect only if it amounts to a deliberate by-passing of state procedure, as explained by *Noia*. This means that if the states hope to terminate a substantial portion of their criminal business in their own courts, the states may not invoke any doctrine of waiver more stringent than this federal concept. The *Noia* definition of an effective waiver promises to pose one of the most troublesome aspects of Supreme Court trilogy. Whatever, we think of it, however, we should understand its consequences and make decisions about state procedure accordingly.[33]

North Carolina deserves praise in its liberal post-conviction hearing statute, but the *Stem* and *McNeil* cases have shown that the federal courts will not be bound by the statute's language concerning waiver.[34] Counsel from the North Carolina Attorney General's office stated in both cases that in spite of the language of the post-conviction statute, North Carolina courts would hear subsequent petitions raising issues available at the time a previous petition was filed.[35] But the court of appeals felt bound by the stated language of the statute.[36] North Carolina in order to bring its statute in line with actual state practice and federal standards, should amend N.C. GEN. STAT. § 15-218 (Supp. 1965) to allow subsequent petitions for post-conviction hearings dealing with claimed denials of constitutional rights that have not been knowingly and deliberately waived by the petitioner, and that have not previously been heard on the merits. In other words, North Carolina should adopt the federal standard of waiver in the post-conviction relief statute. This would add finally to North Carolina state court litigation by allowing the North Carolina courts to make final dispositions of a larger proportion of its criminal cases and eliminate for the federal courts a potential burden of serious proportions.

GEORGE V. HANNA III

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[32] *Id.* at 346-47.
[33] Meador, 50 A.B.A.J. 928, 929-30 (1964).
[34] See note 9 *supra* and accompanying text.
[35] Stem v. Turner, 370 F.2d 895, 897 (4th Cir. 1966). McNeil v. North Carolina, 368 F.2d 313, 316 (4th Cir. 1966).
[36] 370 F.2d at 897.

Insurance—Subrogation—Settlement Between Insured and Tortfeasor

In *Nationwide Mut. Ins. Co. v. Canada Dry Bottling Co.*[1] the North Carolina Supreme Court was faced with the question of subrogation rights of an insurer. The insured's automobile was damaged by the agent of the defendant. The insurer and the insured agreed that the automobile had been damaged in an amount evaluated at $489.14. Fifty dollars was deducted as provided by the policy, and the insurer paid the insured $439.14. The insured instigated an action for property damages (no personal injury was involved) against the defendant for $1,300. The defendant moved that the insurer be made a party to the action, but upon the insured's objection, the court denied the motion. The insurer was said to have "acquiesced" in the denial of the motion. A settlement was made between the insured and the defendant for $400 that was embodied in a consent judgment containing a release of all claims against the defendant. Having become by virtue of its payment to the insured partially subrogated to the claim against the defendant, the insurer brought action against the defendant for recovery of the $439.14. In the present action, the Supreme Court affirmed the trial court's striking of the defendant's pleading of the release as a defense, indicating that a tortfeasor cannot defeat subrogation rights of an insurer by procuring a release from the insured, where the tortfeasor had knowledge of the insurer's payment to the insured.

While this general proposition is rather clear,[2] other aspects of the case and the events going before it present questions.

In the action by the insured against the defendant the latter's motion to have the insurer joined was denied. This ruling was not appealed, so was not before the Court in the instant case. But it remains relevant. As in the federal courts[3] and most other state

[1] 268 N.C. 503, 151 S.E.2d 14 (1966).

[2] Nationwide Mut. Ins. Co. v. Spivey, 259 N.C. 732, 131 S.E.2d 338 (1963); Phillips v. Alston, 257 N.C. 255; 125 S.E.2d 580 (1962); Powell & Powell v. Wake Water Co., 171 N.C. 290, 88 S.E. 426 (1916).

Vance agrees with this rule and also indicates that the tortfeasor, who in good faith and without knowledge of payment by insurer settles with insured, may set this up as bar to insurer's subrogation action. VANCE, THE LAW OF INSURANCE, 794 (3d ed. 1951).

[3] FED. R. CIV. P., 17(a).

jurisdictions,[4] the North Carolina statute[5] requires that an action be brought by, or in the name of, the real party in interest. Where insured property is damaged, the owner of the property has a single and indivisible cause of action against the tortfeasor for the total amount of the loss.[6] In most courts if the insurer has fully indemnified the insured for his loss, the insurer must bring the subrogation suit in its own name, since it is entitled to all fruits of the action and is considered to be the real party in interest.[7] But where the insurer pays only a part of the loss, the insured and the insurer both own portions of the substantive right against the tortfeasor. In this situation the insured generally is a necessary party in any suit against the tortfeasor and is the only plaintiff who may sue alone for the entire claim. When he sues alone he holds the proceeds of judgment as trustee for the insurer to the extent payment was made by the latter.[8] This is an aspect of the rule against splitting a single cause of action and is designed to prevent the tortfeasor from having to defend two actions for the same wrong.[9] But as to the status of the insurer as a party in this partial subrogation situation, the courts differ. North Carolina cases have held that the trial court has discretion to join the insurer as a *proper* party.[10] On the other hand

[4] CLARK, THE LAW OF CODE PLEADING 155 (2d ed. 1947).

[5] N.C. GEN. STAT. § 1-57 (1953).

[6] Service Fire Ins. Co. v. Horton Motor Lines, 225 N.C. 588, 35 S.E.2d 879 (1945); Underwood v. Dooley, 197 N.C. 100, 147 S.E. 686, 64 A.L.R. 656 (1929); Powell & Powell v. Wake Water Co., 171 N.C. 290, 88 S.E. 426 (1916).

[7] Service Fire Ins. Co. v. Horton Motor Lines, 225 N.C. 588, 35 S.E.2d 879 (1945); Underwood v. Dooley, 197 N.C. 100, 147 S.E. 686 (1929); Fireman's Fund Ins. Co. v. Rowland Lumber Co., 186 N.C. 269, 119 S.E. 362 (1923); Powell & Powell v. Wake Water Co., 171 N.C. 290, 88 S.E. 426 (1916); Cunningham v. Seaboard Air Line Ry., 139 N.C. 427, 51 S.E. 1029 (1905); Hamburg-Bremen Fire Ins. Co. v. Atlantic Coast Line Ry., 132 N.C. 75, 43 S.E. 548 (1903). VANCE, THE LAW OF INSURANCE § 134 (3d ed. 1951).

[8] Lumberman's Mut. Ins. Co. v. Southern R.R., 179 N.C. 255, 102 S.E. 417 (1920); Powell & Powell v. Wake Water Co., 171 N.C. 290, 88 S.E. 426 (1916); Fidelity Ins. Co. v. Atlantic Coast Line Ry., 165 N.C. 136, 80 S.E. 1069 (1914).

There might be a question as to whether the insurer has completely paid for the loss when the exact amount of the loss has not been determined. It seems that defendant-tortfeasor is entitled to have this question put in issue. Therefore, when the insured sues, the defendant may plead in defense that there has been complete payoff, so that the insured is not the real party in interest. Jewell v. Price, 259 N.C. 345, 130 S.E.2d 668 (1963); Smith v. Pate, 246 N.C. 63, 97 S.E.2d 457 (1957).

[9] *Ibid.*

[10] Jackson v. Baggett, 237 N.C. 554, 75 S.E.2d 532 (1953); Burgess v.

the federal courts generally hold that the insurer is a *necessary* party, and even though the insured is allowed to sue alone in its own name, if the defendant-tortfeasor objects, the insurer *must* be made a party.[11] But in any event the cause of action remains in this situation single and indivisible.

The defendant here argued before the present court that its intention and that of the insured was that the settlement was to be of the entire claim, so that anything that should go to the insurer is being held by the insured, and the insurer's action should be against the insured. But this argument proved to be unsupportable when confronted with the cases clearly holding that the insurer's subrogation rights cannot be defeated by settlement and release.[12] Thus, defendant could be said to have waived any policy in his favor deriving from the real party in interest and indivisible cause of action rules (*viz.* not having to defend two lawsuits) and has effectively split an initially single cause of action,[13] so that now the way is open to the insurer to bring his subrogation action. Had the defendant allowed insured's action to go to final judgment, no suit would have been maintainable by the insurer. The insured would have been trustee for insurer's share.[14]

There are at least two asserted reasons why either the insurer is not considered to be a necessary party or joinder is denied where it is deemed a proper party. One is that the right of subrogation is equitable, and therefore the legal rights of the subrogor against third persons are unaffected by the subrogation.[15] However, once subro-

Trevatham, 236 N.C. 157, 72 S.E.2d 231 (1952). See N.C. GEN. STAT. § 1-68 (1953), which provides that, "All persons having an interest in the subject of the action and in obtaining the relief demanded may be joined as plaintiffs. . . .; and N.C. GEN. STAT. § 1-69 (1953), which provides that, "All persons may be made defendants, . . . who have, or claim, an interest in the controversy adverse to the plaintiff, or who are necessary parties to a complete determination of the questions involved." See Note, 31 N.C.L. REV. 224 (1953).

[11] See Kansas Elec. Power Co. v. Jarvis, 194 F.2d 942 (10th Cir. 1952); Virginia Elec. & Power Co. v. Carolina Peanut Co., 186 F.2d 816 (4th Cir. 1951); Gas Serv. Co. v. Hunt, 183 F.2d 417 (10th Cir. 1950); National Garment Co. v. N.Y., C. & St. L. Ry., 173 F.2d 32 (8th Cir. 1949). *Contra,* Braniff Airways, Inc. v. Falkingham, 20 F.R.D. 141 (D. Minn. 1957).

[12] See note 2 *supra.*

[13] *E.g.,* Powell & Powell v. Wake Water Co., 171 N.C. 290, 88 S.E. 426 (1916), where the court indicated that while the cause of action was indivisible, it had been divided by the act of the parties.

[14] See note 8 *supra.*

[15] Illinois Cent. Ry. v. Hicklin, 131 Ky. 624, 115 S.W. 752 (1909). But *cf.,* Louisville & N.R.R. v. Mack Mfg. Corp., 269 S.W.2d 707 (Ky. 1954).

gation is established, the subrogee's right to pursue the one liable to the insured assumes the nature of the insured's rights, which are legal in the typical case of a tortfeasor who has damaged the property of the insured.[16] Moreover, in the case where full payment for the loss is made and subrogation is total, the subrogee alone *must* bring the action.[17] Therefore, the insured's rights *are* affected, and to say that the equitable nature of the subrogee's rights determines his status as a party is not true. The second reason is a desire to avoid jury prejudice arising from the knowledge that the injured party's loss is covered by insurance.[18] While this is often perhaps a realistic argument, much of its force is lost when, as in North Carolina, juries know that insurance is a requirement for vehicle registration and that consequently the defendant is (or should be) insured also. The effect of the denial of the defendant's request that the insurer be joined is to make it impossible for him to settle the entire claim by settlement with the sole plaintiff the court has allowed against him. So, if the policy operating here is to protect the insurer for the above reasons, it is at least debatable whether they carry enough force to outweigh the desirability of the defendant's being able to bring the insurer into the action and settle the whole claim. A complete settlement, of course, *could* be made without the insurer in court, but the prospect is not good. As matters now stand, if defendant is liable, the insurer is virtually assured of recovering the full amount of its payment, so there is really no reason for it to settle. But were the insurer brought into court in the original action it might find it more desirable to negotiate.

See Hume v. McGinnis, 156 Kan. 300, 133 P.2d 162 (1943), overruled in Ellis Canning Co. v. International Harvester Co., 174 Kan. 357, 255 P.2d 658 (1953); Atkinson, *The Real Party in Interest Rule: A Plea for its Abolition*, 32 N.Y.U.L. REV. 926, 942 (1957).

[16] United States Cas. Co. v. Anderson Elec. Car Co., 171 App. Div. 543, 157 N.Y. Supp. 710 (1st Dep't 1916). Atkinson, *The Real Party in Interest Rule: A Plea for its Abolition*, 32 N.Y.U.L. REV. 926, 942 (1957).

[17] See note 7 *supra*.

[18] At least one writer feels this is not a legitimate consideration:

> This problem is not met by the courts, and correctly so. The problem is not to change the application of the law, but to defeat the prejudice, if one does exist. There are at least two ways to defeat this prejudice. One is a procedural method to be used to keep the jury from knowing an insurance company is involved in the litigation (referring to payment by the company in the form of a loan receipt), the other is through education of the public in the ideals of justice so they are not prejudiced when they sit as jurors.

Kessner, *Federal Court Interpretations of the Real Party in Interest Rule in Cases of Subrogation*, 39 NEB. L. REV. 452, 462-463 (1960).

In the federal courts the insurer may be brought in on defendant's motion, so the settlement problem does not arise. Some well considered cases by other state courts hold that both the insured and the insurer should be required to join.[19] Even if the North Carolina notion be retained that the insurer is only a proper party, there are strong judicial recommendations that it be joined since it has an ascertainable interest in the subject matter of the controversy.[20] In the present situation, where the defendant who wants to try to settle fails in his effort to have the insurer brought in, he and the courts are faced with another lawsuit by the insurer.

Another problem with the rule as it stands is that the defendant risks double payment when he settles. In the instant case the Court "noted" that the insured's action against the defendant was for damages in the amount of $1,300,[21] but did not discuss the significance of this fact. Of course, at the present stage of the proceedings the full amount of damages has not been determined. The insurer is asking for the $439.14 it paid to its insured. If the actual damage is determined to be greater, this figure will still be the limit of the insurer's recovery, because it had subrogation rights to no more. There is, of course, no further liability to the insured because of the release. But if damages are ascertained to be somewhat close to $400,[22] it would appear that the defendant is perhaps going to have to pay twice—that is, he has already paid $400 for the release, and, if unsuccessful in the present action, will have to pay the insurer $439.14 more. Are there procedures available so that he might avoid this?

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[19] Louisville & N.R.R. v. Mack Mfg. Corp., 269 S.W.2d 707 (Ky. 1954); Pratt v. Radford, 52 Wis. 114, 8 N.W. 606 (1881). See Porter v. Lane Constr. Corp., 212 App. Div. 528, 209 N.Y. Supp. 54 (4th Dep't 1925), *aff'd mem.*, 244 N.Y. 523, 155 N.E. 881 (1926).

[20] Justice Ervin, in Burgess v. Trevatham, 236 N.C. 157, 72 S.E.2d 231 (1952), cites Service Fire Ins. Co. v. Horton Motor Lines, Inc., 225 N.C. 588, 35 S.E.2d 879 (1945) and Lumberman's Mut. Ins. Co. v. Southern R.R., 179 N.C. 255, 102 S.E. 417 (1920) as sanctioning Professor McIntosh's statement that "[T]here would seem to be no valid objection to joining the insured and the insurer as parties under the general provision for the joinder of parties, so that all parties interested could be before the court. . . ." McINTOSH, NORTH CAROLINA PRACTICE & PROCEDURE IN CIVIL CASES 203 (1929). See Equitable Life Assur. Soc'y v. Basnight, 234 N.C. 347, 67 S.E.2d 390 (1951).

[21] Nationwide Mut. Ins. Co. v. Canada Dry Bottling Co., 268 N.C. 503, 506, 151 S.E.2d 14, 16 (1966).

[22] That the insurer and the insured agreed that damages sustained were $489.14 would indicate that the amount probably will be rather close.

Where the insurer pays the full amount of the loss to its insured, it is the real party in interest. But the first action having terminated with the settlement and before damages were assessed, it was not known whether the insurer had fully indemnified the insured. If it now appears that the $439.14 covers the entire damages, and the insurer should have been the real party in interest, the defendant could argue that it would be inequitable for the insured to retain the settlement money where it was not the proper party in the suit. The countervailing argument is that the defendant has waited too long to raise the issue and will be estopped to allege at this point that the party he settled with was not the real party in interest.[23] The more serious difficulty is that the insured is not in the present suit; and, as discussed below, it seems unlikely that the defendant join the insured in order to make the argument.

It would seem that the general principles of indemnity[24] would require that the defendant not be subjected to this possible double payment. If the insured has been fully indemnified by the payment from its insurer, and is allowed to keep the settlement money, there would appear to be an inequity. Balance could be restored by requiring the insured to return to the insurer all above the amount required to compensate him for his loss. But it is difficult to see how the defendant can effect this result. While there are many cases which allow the insurer to obtain reimbursement of money obtained by its insured who settles with the tortfeasor, they depend upon the insured having by such settlement cut off the insurer's rights to

[23] Authority for this argument might be found in the court's statement in Phillips v. Alston, 257 N.C. 255, 259, 125 S.E.2d 580, 583 (1962):

> While a tortfeasor is entitled to have the total damages ascertained in one action, he cannot, when he has knowledge of insurer's rights by virtue of its payment to the owner, defeat those rights by making payment to and taking a full release from the owner. The payment so made and release taken will be *construed* as a mere adjustment of the *uncompensated* portion of the loss. (Italics added.)

It appears from this that the court would not allow the defendant to settle before putting in issue whether there has been full payment by insured, and then later maintain that there had indeed been full payment.

[24] Vance says that:

> the basis of the contract of insurance on property is indemnity. Indemnity is its sole legitimate purpose, and any contract that contemplates a possible gain to the insured by the happening of the event upon which the liability of the insurer becomes fixed is contrary to the proper nature of insurance, and, in the absence of statute, will not be allowed.

VANCE, THE LAW OF INSURANCE 101 (3d ed. 1951).

go against the tortfeasor.[25] But in this case the insurer's subrogation rights were not destroyed, making it doubtful that such a reimbursement possibility is open. Moreover, the insurer has not chosen to proceed for reimbursement but has brought an action against the defendant. The question then becomes whether, if reimbursement is possible, the defendant can have the insured joined as a party. While there are some possible analogous decisions,[26] they are not really very closely related and the prospect seems doubtful.

Unless it was fairly evident that damages were going to run to a significantly larger figure, the defendant, who paid for a settlement with the insured and still faces a subrogation action by the insurer, has made a rather bad bargain. The danger of such a bargain could be avoided, and just settlement encouraged, if procedural devices were available to require that all parties needed for final and complete settlement could be joined in the suit.

ROBERT L. THOMPSON

Jury—Allowing Challenge for Cause to a Prospective Juror Opposed to Capital Punishment

In *State v. Childs*[1] defendant was found guilty of rape and burglary in the first degree and sentenced to death. Appeal was made on the ground *inter alia* that the trial judge erred in granting the State's challenges for cause to prospective jurors on the ground that they had conscientious scruples against the infliction of the

[25] See cases collected in 29A AM. JUR. INSURANCE § 1736 (1960).

[26] One sued by subrogated insurer for having destroyed the property may require all other insurance companies participating in paying the loss to be made parties to the action. Powell & Powell v. Wake Water Co., 171 N.C. 290, 88 S.E. 426 (1916). While a fire insurance company, which pays a loss, is proportionately subrogated to the insurer's right of action against the tortfeasor, the insurer must work out his remedy through the insured, so, where several insurance companies each paid part of a loss, it was proper, where separate actions by the several insurance companies were consolidated, to make the insured a party. Lumberman's Mut. Ins. Co. v. Southern R.R., 179 N.C. 255, 102 S.E. 417 (1920). See United States v. Aetna Cas. & Sur. Co., 338 U.S. 366 (1949) where the Court held that where an insurer has become partially subrogated to the rights of an insured under the Federal Tort Claims Act, both are "necessary parties" but not "indispensible parties" and either party may sue, although in such case the United States upon timely motion may compel their joinder.

[1] 269 N.C. 307, 152 S.E.2d 453 (1967).

death penalty. The North Carolina Supreme Court found no error. It said:

> It is a general rule that the State in the trial of crimes punishable by death has the right to an impartial jury, and in order to secure it, has the right to challenge for cause any prospective juror who is shown to entertain beliefs regarding capital punishment which would be calculated to prevent him from joining in any verdict carrying the death penalty.[2]

The practice of excusing, on a challenge for cause, any prospective juror who is opposed to capital punishment is followed in the federal courts[3] and in the majority of state courts by either statute[4] or judicial decision.[5] This practice originated at a time when conviction of a capital crime meant a compulsory death sentence,[6] and the theory behind the practice is obvious. In a case where a finding of guilty would automatically mean the death penalty, a juror opposed to capital punishment would never vote in favor of the defendant's guilt, thus prejudicing the prosecution.

Today most states, including North Carolina, have abolished the mandatory death penalty.[7] Statutes in those states now give the jury discretion as to the punishment to be imposed.[8] Under such statutes the jury first decides whether the defendant is guilty or innocent of

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[2] *Id.* at 317-18, 152 S.E.2d at 461.

[3] Turberville v. United States, 303 F.2d 411 (D.C. Cir. 1962), *cert. denied*, 370 U.S. 946 (1962).

[4] *E.g.*, CAL. PEN. CODE § 1074: "A challenge for implied bias may be taken for all or any of the following causes and no other . . . 8. If the offense charged by punishable with death, the entertaining of such conscientious opinions as would preclude his finding the defendant guilty; in which case he must neither be permitted nor compelled to serve as a juror."

[5] State v. Childs, 269 N.C. 307, 152 S.E.2d 453 (1967). See Annot., 48 A.L.R.2d 560 (1956).

[6] *E.g.*, State v. Vann, 162 N.C. 534, 77 S.E. 295 (1913).

[7] See Knowlton, *Problems of Jury Discretion in Capital Cases*, 101 U. PA. L. REV. 1099 (1953).

[8] In North Carolina the death penalty may be imposed for murder in the first degree, N.C. GEN. STAT. § 14-17 (1953); rape, N.C. GEN. STAT. § 14-21 (1953); burglary in the first degree, N.C. GEN. STAT. § 14-52 (1953); and arson, N.C. GEN. STAT. § 14-58 (1953). In each of these statutes is the following provision: "Provided, if at the time of rendering its verdict [of guilty of a capital crime] in open court, the jury shall so recommend, the punishment shall be imprisonment for life in the State's prison, and the court shall so instruct the jury." This provision gives the jury "an unbridled discretionary right" to recommend that punishment for the crime shall be imprisonment for life in lieu of death in all cases where a verdict of guilty of a capital crime has been reached. State v. McMillan, 233 N.C. 630, 633, 65 S.E.2d 212, 213 (1951).

the crime charged. If guilty, the jury then decides what the punishment shall be—the death penalty or life imprisonment. Since the death penalty is no longer automatically imposed by the jury upon a finding of guilty, can it still be said that a juror opposed to capital punishment may be prevented by that opposition from joining a verdict of guilty? The courts of two states have said not.

In *State v. Lee*[9] the Iowa Supreme Court held it error to allow a challenge for cause to a prospective juror who was opposed to capital junishment. The court said:

> It cannot be said that the state is entitled to have the punishment by death inflicted in any case. The statute authorizes that punishment, in the discretion of the jury, . . . but the state has no right to a trial by jurors who have no objection against inflicting the death penalty, except as it can secure them by challenging peremptorially those who have such objections.[10]

In *State v. Garrington*[11] the South Dakota Supreme Court, in upholding the trial judge's refusal to allow challenge for cause on these grounds, agreed that under a statute mandatorially imposing the death penalty upon a finding of guilty, a juror opposed to capital punishment would not find the defendant guilty. But where the jury has discretion as to punishment "the entertaining of such opinions does not have that effect, and is not a cause for challenge."[12]

There is a further challenging theory supporting the proposition that persons opposed to capital punishment should not be excluded from juries in capital cases. Basically it is that a jury from which such persons have been excluded "will necessarily have been culled of the most humane of its prospective members"[13] and will contain members who, consciously or unconsciously, will be more prone to convict, and tend to find a particular defendant guilty on less evidence than would a jury from which persons opposed to capital punishment were not excluded.[14] Professor Walter E. Oberer[15] proposes the argument thusly:

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[9] 91 Iowa 499, 60 N.W. 119 (1894).
[10] *Id.* at 502, 60 N.W. at 121.
[11] 11 S.D. 178, 76 N.W. 326 (1898).
[12] *Id.* at 184, 76 N.W. at 327.
[13] Oberer, *Does Disqualification of Jurors for Scruples Against Capital Punishment Constitute Denial of Fair Trial On Issue of Guilt?*, 39 TEXAS L. REV. 545, 549 (1961). [Hereinafter cited as Oberer]
[14] This theory is pointedly supported in ADORNO, FRENKEL-BRUNSWIK, LEVINSON, & SANFORD, THE AUTHORITARIAN PERSONALITY (1950). [Here-

> (1) Under modern statutes the guilt issue has been separated from the punishment issue. (2) The necessity which justified death-qualification under the old mandatory, one-issue statutes no longer obtains. (3) A jury qualified to the prosecution's satisfaction on the punishment issue is correspondingly disqualified from the defendant's standpoint on the guilt issue. (4) The logical consequence is that when the same jury decides both issues, the defendant is denied due process of law through having forced upon him a partial jury on the most critical issue in the case—that of guilt or innocence.[16]

Persons opposed to capital punishment form a sizeable and definite class in our society, and those in favor of capital punishment are actually in a minority.[17] Of the people in favor of capital punishment, many do not like the idea of having anything to do with it themselves.[18] Can it be said then that a jury composed of such a class of persons, who are in a minority in our society and who may tend to more quickly find a criminal defendant guilty on less evi-

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inafter cited as ADORNO]. This book, a study on prejudice, includes data indicating that there are persons possessing certain personality traits in varying degrees. Among these traits are certain attitudes toward people. On one end of the scale are persons with attitudes such as moralistic condemnation of other people, the tendency to blame other people rather than oneself, general suspiciousness and distrust of others, orientation towards persons in positions of power and authority, and an exploitive-manipulative-opportunistic attitude. The persons on this end of the scale will externalize and project their hostile feelings by conceiving of others as threatening and dangerous. On the other end of the scale are persons who feel permissive toward other people, who tend to refrain from blaming others, who feel trustingness and openess and see people as essentially "good" until proved otherwise, who conceive of the environment as congenial rather than dangerous, and who tend persistently to strive for realization of productive social values. Between these two extremes lie the greater percentage of people possessing these traits in different degrees. *Id.* at 405-15.

See also WEIHOFEN, THE URGE TO PUNISH (1956).

In Turberville v. United States, 303 F.2d 411, 420 (D.C. Cir. 1962), *cert. denied*, 370 U.S. 946 (1962), the court noted that there was a "thesis in this area of the law . . . that persons who are not opposed to capital punishment are psychologically inclined against criminals and therefore a jury composed of such persons is not an impartial jury." This thesis was rejected by the court without extensive consideration.

[15] See note 13 *supra*.

[16] Oberer 555.

[17] A recent poll indicated that forty-three percent of the people in the United States are opposed to capital punishment for persons convicted of murder; this figure rose from twenty-five per cent in 1953. Twelve per cent of the people have no opinion. This left forty-five per cent in favor of capital punishment for persons convicted of murder. Press release by the Gallup Institute dated February 5, 1965 on file in Wilson Library at University of North Carolina at Chapel Hill.

[18] WEIHOFEN, THE URGE TO PUNISH, 168 (1956).

dence, does not deprive that defendant of due process of law? In two recent cases attention has been focused on the constitutional aspects of the problems of exclusion from juries of members of definite and sizeable classes in society.

In *Labat v. Bennett*[19] the Court of Appeals for the Fifth Circuit held *inter alia* that systematic total exclusion of daily wage earners as a class violated the criminal defendant's due process and equal protection rights to an impartial jury representing a cross-section of the community.[20]

In a different context is *Schowgurow v. State*.[21] There the Maryland Court of Appeals held that the provisions "of the Maryland Constitution requiring demonstrations of belief in God as a qualification for service as a grand or petit juror are in violation of the Fourteenth Amendment, and that any requirement of an oath as to such belief, or inquiry of prospective jurors, oral or written, as to whether they believe in a Supreme Being is unconstitutional."[22]

These cases indicate that when a state systematically and totally excludes from the jury a sizeable and clearly defined class of persons, such as those opposed to capital punishment, a criminal defendant is denied a jury drawn from a cross-section of society and his constitutional rights have thus been invaded.

[19] 365 F.2d 698 (5th Cir. 1966), *petition for cert. denied*, 35 U.S.L. WEEK 3272 (U.S. Jan. 10, 1967) (No. 956).

[20] In *Labat* the court relied upon the words of the United States Supreme Court in Thiel v. Southern Pacific Co., 328 U.S. 217 (1946); Glasser v. United States, 315 U.S. 60 (1942); and Smith v. Texas, 311 U.S. 128 (1940). The court in *Smith* said, "It is part of the established tradition in the use of juries as instruments of public justice that the jury be a body truly representative of the community." 311 U.S. at 130. In *Glasser* it was pointed out that "the proper functioning of the jury system, and, indeed our democracy itself, requires that the jury be a 'body truly representative of the community,' and not the organ of any special group or class." 315 U.S. at 86.

In Fay v. New York, 332 U.S. 261 (1947), the Court rejected a constitutional challenge to purported exclusion from juries, by the state of New York, of working class people in order to form a "blue-ribbon" jury. However, it should be noted that the Court accepted the proposition that a jury should represent a cross-section of the community, and based its opinion heavily upon the lack of evidence that any "person was excluded because of his occupation or economic status." *Id.* at 291. Further, in *Theil* the Court stated that exclusion of daily wage earners "cannot be justified by federal or state law," although it rested its decision that daily wage earners cannot be excluded from federal juries upon its supervisory powers. 328 U.S. at 222.

[21] 240 Md. 121, 213 A.2d 475 (1965).

[22] *Id.* at 131, 213 A.2d at 482.

A questionable point in the argument against excluding those opposed to capital punishment is that if the jurisdiction requires that the jury be unanimous in its decision on punishment, whether it be death or life imprisonment, as well as guilt, then one juror opposed to capital punishment could prevent a unanimous vote for the death penalty. Among the states that have considered the particular question, there is a split of authority.[23] Some states require unanimity on both guilt and punishment.[24] Others hold that if the verdict is guilty of the capital crime and the jury does not vote unanimously to recommend life imprisonment, the death penalty will automatically be imposed; so there does not have to be a unanimous vote in order to impose the death penalty.[25]

No case has been found in which the North Carolina Supreme Court has been faced with this question. The North Carolina statutes provide that certain crimes "shall be punished with death: Provided, if at the time of rendering its verdict in open court, the jury shall so recommend, the punishment shall be imprisonment for life. . . ."[26] From this wording it would appear that if the jury did not unanimously so recommend, the death penalty would be imposed. If this interpretation were placed upon the statute by the court, then some jury members opposed to capital punishment could not prevent imposition of the death penalty. If the position taken was that the jury must be unanimous as to which penalty is to be imposed, then one juror *could* prevent the death penalty from being imposed. However, it is suggested that in this situation it should be possible to have a bifurcated trial. In the first stage, a jury from which no one opposed to capital punishment was excluded would consider the defendant's guilt or innocence. If the defendant is found guilty, the trial would move into the second stage with a jury from which everyone opposed to capital punishment was excluded. This jury would consider the punishment to be imposed. Admittedly, this process would require more time and be more expensive to the state. However in this way the defendant's interest in

[23] Annot., 1 A.L.R.3d 1461 (1965); Annot., 92 L. Ed. 2d 1072 (1948); Knowlton, *Problems of Jury Discretion in Capital Cases*, 101 U. PA. L. REV. 1099, 1125 (1953).

[24] *E.g.*, State v. Reynolds, 41 N.J. 163, 195 A.2d 449 (1963), *cert. denied*, 377 U.S. 1000 (1964).

[25] *E.g.*, Commonwealth v. McNeil, 328 Mass. 436, 104 N.E.2d 153 (1952).

[26] N.C. GEN. STAT. §§ 14-17, 21, 52, 58 (1953).

an impartial jury on the question of his guilt, as well as the prosecution's interest in an impartial jury on the question of punishment, would be protected. Certainly the desire to see that a criminal defendant, who may lose his life, gets a decision as to his guilt by a fair and impartial jury outweighs considerations of the time and cost of this procedure.[27]

The courts and legislatures must face the realization that exclusion from the jury of persons opposed to capital punishment continues as a vestige of an ancient rule of law that had its origin under the now non-existant mandatory death penalty statutes. They should be made aware of the psychological data indicating that a jury from which this large segment of society has been excluded may result in prejudice to the defendant on the question of his guilt. Decisions must be made on whether the present practice is to continue, and, if so, what interest society has in its continuation. Hopefully, the constitutional implications of this practice will lead to judicial decisions or legislation to the effect that these persons should no longer be excluded from the jury in capital cases. If the present

[27] The necessity of bifurcated trials has been recognized by other courts. In Holmes v. United States, 363 F.2d 281 (D.C. Cir. 1966) the court noted the prejudicial effect of pleading the defense of insanity and the defense of not guilty before the same jury and stated that the trial judge could impanel a second jury to hear evidence on the insanity issue, after the first jury had considered the issue of guilt, "if this appears necessary to eliminate prejudice." *Id.* at 283.

Another example is the situation in which the jury determines the voluntariness of a criminal defendant's confession, and then, upon a finding that it was involuntary and excludable, proceeds to determine the defendant's guilt. The United States Supreme Court in Jackson v. Denno, 278 U.S. 368 (1964) found this practice unconstitutional and held that the same jury should not decide both issues.

Examples of statutory provisions for bifurcated trials can be seen in California, CAL. PEN. CODE § 190.1, and in New York, N.Y. PEN. LAW § 1045-a. Under these statutes the trial court may for good cause discharge the jury that decided the guilt question in a capital case, and impanel a new one to decide the question of punishment; other wise the same jury will decide both issues. It should be noted that the Supreme Court of California recently rejected, with little discussion, the contention of a criminal defendant that since the trial court could discharge the jury deciding the guilt issue in a capital case, there was no reason for the judge to sustain challenges for cause to prospective jurors who indicated that they could not vote for the death penalty. The court read into the statute a "legislative directive" that "whenever possible the same jury shall serve at both phases of the trial by reasons of continuity and economy of effort." People v. Smith, 63 C.2d 779, ——, 48 Cal. Rptr. 382, 389, 409 P.2d 222, 229 (1966).

For a discussion of the right to a bifurcated trial in general, see 45 N.C.L. REV. 541 (1967).

practice continues the bifurcated trial process could be utilized to avoid the unfairness of the present situation.

PENDER R. MCELROY

Labor Law—Breach of the Duty of Fair Representation as an Unfair Labor Practice

Since 1962 the National Labor Relations Board has held that the failure of a union to represent its members fairly is an unfair labor practice.[1] The NLRB has used Sections 8(b)(A),[2] 8(b)2[3] and 8(b)3[4] of the National Labor Relations Act to reach this result.

[1] Miranda Fuel Co., 140 N.L.R.B. 181 (1962), *enforcement denied*, 326 F.2d 172 (2d Cir. 1963). See *e.g.*, Local 12, United Rubber Workers, 150 N.L.R.B. 312 (1964); Automobile Workers Union, 149 N.L.R.B. 482 (1964); Local 1367, Int'l Longshoremen's Ass'n, 148 N.L.R.B. 897 (1964); Independent Metal Workers Union, 147 N.L.R.B. 1573 (1964).

[2] Section 8(b)1 provides in part that it shall be an unfair labor practice for a union or its agents "to restrain or coerce (A) employees in the exercise of the rights guaranteed in section 7: *Provided*, That this paragraph shall not impair the right of a labor organization to prescribe its own rules with respect to the acquisition or retention of membership therein. . . ." Labor Management Relations Act (Taft-Hartley Act), 61 Stat. 140 (1947), 29 U.S.C. § 158(b)(1) (1964).

Section 7 provides "Employees shall have the right to self-organization, to form, join, or assist labor organizations, to bargain collectively through representatives of their own choosing, and to engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection, and shall also have the right to refrain from any or all of such activities. . . ." 61 Stat. 140 (1947), 29 U.S.C. § 157 (1964).

[3] Section 8(b)2 provides in part that it shall be an unfair labor practice for a union or its agents "to cause or attempt to cause an employer to discriminate against an employee in violation of subsection (a)(3) or to discriminate against an employee with respect to whom membership in such organization has been denied or terminated on some ground other than his failure to tender the periodic dues and the initiation fees uniformly required as a condition of acquiring or retaining membership. . . ." 61 Stat. 141 (1947), 29 U.S.C. § 158(b)(2) (1964).

Section 8(a)3 provides that it shall be an unfair labor practice for an employer "by discrimination in regard to hire or tenure of employment or any term or condition of employment to encourage or discourage membership in any labor organization. . . ." 61 Stat. 140 (1957), 29 U.S.C. § 158(a)(3) (1964).

[4] Section 8(b)3 provides that it shall be an unfair labor practice for a union or its agents "to refuse to bargain collectively with an employer, provided it is the representative of his employees subject to the provisions ship in any labor organization. . . ." 61 Stat. 140 (1947), 29 U.S.C. § 158(b)(3) (1964).

Section 8(d) provides in part "to bargain collectively is the performance of the mutual obligation of the employer and the representative of the em-

Until recently appellate review of these opinions has been limited to one inconclusive case.[5] Now the Court of Appeals for the Fifth Circuit, in a landmark decision, has approved the Board's use of Section 8(b)(1)(A) to reach unfair representation by unions, leaving unanswered the question of whether or not the Board's reliance on Section 8(b)2 and 8(b)3 was proper.

In *Local 12, United Rubber Workers v. NLRB*[6] the local union had refused to process the grievances of eight Negro members concerning discrimination in employment. The Negroes complained that racially separate plant facilities were maintained. Further, they complained that separate seniority rolls for white male, Negro male, and female employees were maintained prior to 1962 despite the fact that the bargaining contract appeared to give seniority without regard to race or sex. During this period the complainants had been laid off for a year. The eight Negro employees executed affidavits that during the period of the layoff new white workers had been hired in violation of their seniority rights. The union grievance committee concluded that no contract violation existed and that a union complaint would therefore be baseless. The complainants appealed within the union structure and the union's international president held that the grievance should be processed. However, Local 12 still refused to process the grievances and in October 1962 unfair labor practices charges were filed with the labor board. The Court of Appeals affirmed the NLRB's finding of a Section 8(b)(1)(A) violation,[7] but failed to consider the Board's application of Sections 8(b)2 and 8(b)3 to the case.

Neither the National Labor Relations Act nor the Railway Labor Act[8] specifically states that a union owes a duty of fair representation to the employees it represents. The concept of fair representation had its genesis in *Steele v. Louisville & N.R.R.*,[9] a 1944 de-

ployees to meet at reasonable times and confer in good faith with respect to wages, hours, and other terms and conditions of employment, or the negotoation of an agreement, or any question arising thereunder, and the execution of a written contract . . . but such obligation does not compel either party to agree to a proposal or require the making of a concession. . . ." 61 Stat. 140 (1947), 29 U.S.C. § 158(d) (1964).

[5] Miranda Fuel Co., 140 N.L.R.B. 181 (1962, *enforcement denied*, 326 F.2d 172 (2d Cir. 1963). The decision by a three judge panel involved a majority opinion, a concurrence on different grounds and a dissent.

[6] 368 F.2d 12 (5th Cir. 1966).

[7] *Id.* at 24.

[8] 44 Stat. 577 (1926), as amended, 45 U.S.C. §§ 151-63 (1964).

[9] 323 U.S. 192 (1944).

cision of the United States Supreme Court. There the court held that a union could not negotiate a contract which would result in Negro employees, who were not union members, losing job opportunities. The court found that under the Railway Labor Act a union is given the exclusive right to represent all employees and as the exclusive bargaining representative is required to "represent nonunion or minority union members of the craft without hostile discrimination, fairly, and impartially, and in good faith."[10] This is not to say that there cannot be relevant differences, but "discriminations based on race alone are obviously irrelevant and individious."[11] Because Section 9(a)[12] of the National Labor Relations Act makes the union an exclusive bargaining agent, the Supreme Court in *Wallace Corp. v. NLRB*[13] recognized that the duty of fair representation exists under this act also.

Steele and *Wallace* may have seemed sufficient for the enforcement of the duty of fair representation, but they actually established a judicial remedy of limited value.[14] A party faced delay, expense, and technical barriers when he carried his complaint into the courts. The first application of the effective administrative remedy of unfair labor practice proceeding[15] for breach of the duty of fair repre-

[10] *Id.* at 204.

[11] *Id.* at 203.

[12] Section 9(a) provides " Representatives designated or selected for the purposes of collective bargaining by the majority of the employees . . . shall be the exclusive representatives of all the employees in such unit for the purposes of collective bargaining in respect to rates of pay, wages, hours of employment, or other conditions of employment. . . ." 61 Stat. 143, U.S.C. § 159(a) (1964).

[13] 323 U.S. 248 (1944).

[14] For discussions on the sufficiency of the judicial remedy see SOVERN, LEGAL RESTRAINTS ON RACIAL DISCRIMINATION IN EMPLOYMENT 144-60 (1966); Cox, *The Duty of Fair Representation*, 2 VILL. L. REV. 151, 172-77 (1957); Murphy, *The Duty of Fair Representation under Taft-Hartley*, 30 Mo. L. REV. 373, 374-77 (1965); Rosen, *The Law and Racial Discrimination in Employment*, 53 CALIF. L. REV. 729, 771-81 (1965); Sovern, *The National Labor Relations Act and Racial Discrimination*, 62 COLUM. L. REV. 563, 609-13 (1962).

[15] There are other administrative remedies available in addition to unfair labor practice proceedings. One method used by the Board to discourage a union becoming or remaining an exclusive representative is the removal of the contract bar. Normally the NLRB makes a collective bargaining agreement a bar to a new election for three years. However, in Pioneer Bus Co., 140 N.L.R.B. 54 (1962) the Board implied that discrimitory contracts would not bar a new election. Independent Metal Workers Union, 147 N.L.R.B. 1573 (1964) the Board overruled previous decisions which allowed a union to retain certified status while it excluded

sentation came in 1962 with *NLRB v. Miranda Fuel Co.*[16] The union had requested that one of its members be reduced in seniority when circumstances indicated no valid reason for this demand. Under pressure from the union the employer acquiesced and the employee was reduced in seniority. The majority of the Board indicated that Section 7 protected employees from such "invidious treatment by their exclusive bargaining agent in matters affecting their employment."[17] The remedy for such discrimination was available under Section 8(b)(1)(A). Further, the Board found violations of Sections 8(b)2 and 8(b)3[18] which impose duties on both unions and employers not to conduct themselves in such a manner as to encourage or discourage union membership. Presumably, the union by demonstrating its arbitrary power forced non-members and members in poor standing to become active in union affairs to preserve their jobs.[19] Two Board members dissented in *Miranda* pointing out that the concept of fair representation had not been advanced or litigated in the case and that the legislative history of the act did not support the interpretation of the majority.[20] On appeal enforcement was denied, but the court was badly split and did not really decide whether the new theory was valid.[21] Until *Rubber Workers* this was the only appellate decision dealing with fair representation as an unfair labor practice.

Racial discrimination was not involved in *Miranda* so it remained for *Hughes Tool*[22] to extend the theories of *Miranda* into that area. In *Hughes Tool* Locals 1 and 2 of the Independent Metal Workers Union had been certified as joint bargaining representatives; Local 1 was white and Local 2 was Negro. After a bid for an apprenticeship by a Negro employee was refused consideration by the company, the grievance committee of Local 2 protested.

Negro employees from membership and classified or segregated its members on a racial basis.

[16] 140 N.L.R.B. 181 (1962), *enforcement denied*, 326 F.2d 172 (2d Cir. 1963).

[17] 140 N.L.R.B. at 185.

[18] *Id.* at 185.

[19] See note 3 *supra.*

[20] *Accord*, Murphy, *The Duty of Fair Representation Under Taft-Hartley*, 30 Mo. L. REV. 373, 382 (1965). *Contra*, SOVERN, LEGAL RESTRAINTS ON RACIAL DISCRIMINATION IN EMPLOYMENT 163 (1966) where it is averred that Congress implicitly accepted *Steele* and gave Negroes the right of equal treatment when Taft-Hartley was enacted in 1947.

[21] 326 F.2d at 172.

[22] 147 N.L.R.B. 1573 (1964).

When this failed to get results, Local 1 was asked to intervene. The Board affirmed the trial examiners finding that Sections 8(b)(1)(A), 8(b)2, and 8(b)3 were violated because Local 1 refused to process grievances as requested.

In *Hughes Tool* the majority of the Board expanded its theory to include Section 8(b)3, and the dissenters of *Miranda* clarified their opposition to holding unfair representation an unfair labor practice. The principal dispute among the Board members concerned the technicalities of the application of the first three Sections of 8(b) to fair representation, but there was a related schism involving the philosophy of the function of the NLRB. In *Hughes Tool* the majority of the Board cited *Brown v. Board of Educ.*[23] and *Shelley v. Kraemer*[24] for the proposition that racial segregation in union membership, when engaged in by an exclusive bargaining agent under the NLRA, cannot be condoned by a "Federal Agency."[25] This line of thought can be linked to the *Steele* case which recognized the possibility that a favored status under a statute might be enough to make collective bargaining governmental action and hold a union to constitutional standards.[26] However, no Supreme Court opinion has yet held that the Constitution requires a union and employer not to discriminate.[27] The reasoning of the majority in effect makes the NLRB a fair employment practices committee for it becomes the function of the Board to use its power to eliminate discrimination.

The minority of the Board replied that Congress up to that time had been unable to pass fair employment legislation and that it was clearly not the congressional intent that the NLRA operate as a substitute.[28] Further, it may be argued that collective bargaining operates best with a minimum of interference, governmental or otherwise. For this reason application of constitutional standards to fair representation by unions might disrupt collective bargaining by requiring burdensome judicial and administrative regulation. It appears possible to the advocates of the minority view that the application of constitutional standards to collective bargaining could seri-

[23] 347 U.S. 483 (1954).
[24] 334 U.S. 1 (1948).
[25] 147 N.L.R.B. at 1574 & n.3.
[26] For a discussion of this possibility see Rosen, *The Law and Racial Discrimination in Employment*, 53 CALIF. L. REV. 729, 750-56 (1965).
[27] *Steele* was based on an interpretation of the Railway Labor Act.
[28] Hughes Tool, 147 N.L.R.B. 1573, 1578-93 (1964) (separate opinion).

ously hamper[29] the Board in implementing the act's principal goal of promoting union-employer relations because strict constitutional standards would result in a loss of necessary flexibility in collective bargaining.[30]

The advocates of each viewpoint manifest the basic split in philosophy by their varied interpretations of Section 8(b) and its related provisions. The approach of the minority of the Board emphasizes statutory intent and is strictly an argument of logic, while the results reached by the majority, although at times seemingly based on illogical reasoning, are more equitable. An example of this is the interpretation put on Section 8(b)(1)(A) by the majority of the Board in *Rubber Workers*.[31] The reasoning in this opinion was simply that by refusing to process grievances the respondent union "restrained or coerced" the Negro employees in exercising their right to be represented without invidious discrimination. The Board stated simply that there was no justification for the refusal to process the grievances since the sole reason for the refusal was racial discrimination. The dissenters freely admitted a duty of fair representation under Section 9(b),[32] but indicated that there was nothing in the legislative history to indicate a congressional intent to make fair representation a protected Section 7 right.[33] They argued that an unfair labor practice occurs only where there is conduct relating to "union membership, loyalty, the acknowledgment of union authority, or the performance of union obligation."[34] Reasoning that the refusal to process a grievance did not relate to any of these factors, the minority found no unfair labor practice within the meaning of Section 8(b)(1)(A). The fifth circuit expressly repected this narrow view of Section 8(b)(1)(A) stating that the breach of every

[29] See Rosen, *The Law and Racial Discrimination in Employment*, 53 CALIF. L. REV. 729, 754-56 (1965).

[30] *Id.* at 755.

[31] 150 N.L.R.B. at 312.

[32] Section 9(b) provides:

> The Board shall decide in each case whether, in order to assure to the employees the fullest freedom in exercising the rights guaranteed by this subchapter, the unit appropriate for the purposes of collective bargaining shall be the employer unit, craft unit, plant unit, or subdivision thereof. . . .

61 stat. 143 (1947), 29 U.S.C. § 159(b) (1964).

[33] 150 N.L.R.B. at 324 (dissenting opinion).

[34] *Id.* at 325.

other duty imposed by the act has been held an unfair labor practice and there is no reason for this single exception.[35]

Still unanswered by the court is the propriety of the Board's use of Sections 8(b)2 and 8(b)3 to enforce the duty of fair representation. Section 8(b)(1)(A) specifically gives a union the right to establish its own regulations concerning membership, but in light of *Steele* it is unclear whether a union may exclude Negroes from membership on the arbitrary and invidious basis of race.[36] However, Section 8(b)2 and 8(a)3 make it clear that if workers denied membership are then denied jobs the law is violated.[37] The disagreement between the majority and the minority of the Board is over the conclusion of the majority that Section 8(b)2 and 8(a)3 are violated regardless of union membership or lack of it, when for "arbitrary or irrelevant reasons or upon the basis of an unfair classification, the union attempts to cause or does cause an employer to derogate the employment status of an employee."[38] The critical question is whether the conclusion of the Board is tenable on the somewhat strained logic that an employee will be encouraged to be a "good union" member because he sees the union coerce the employer to arbitrarily discriminate against a fellow worker. The minority sees no direct effect on union membership by such arbitrary conduct for the discrimination is unrelated to the union activities of the employee.[39] Although this view is logical, the majority position seems more responsive to actual human behavior. Fear of the union's power to discriminate arbitrarily results in union members striving to remain on good terms with the union, and this necessarily entails maintaining union membership.

The use of Section 8(b)3 by the Board to reach unfair representation by the union raises some interesting problems of statutory interpretation. This section can be viewed in at least two ways as observed by Professor Archibald Cox:

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[35] 368 F.2d 12, 21 (5th Cir. 1966).

[36] See 93 CONG. REC. 4193 (1947) (remarks of Senator Taft).

[37] See SOVERN, LEGAL RESTRAINTS ON RACIAL DISCRIMINATION IN EMPLOYMENT 165 (1966).

[38] Miranda Fuel Co., 140 N.L.R.B. 181, 186 (1962), *enforcement denied*, 326 F.2d 172 (2d Cir. 1963).

[39] Local 12, United Rubber Workers, 150 N.L.R.B. 312 (1964). The same division present on the Board in *Miranda* continues here but is clarified to some extent.

> The critical inquiry would seem to be whether section 8(b)3 should be construed: (1) to regulate only the union's conduct in relation to employer, or (2) to embody all its statutory obligations in negotiating or administering an agreement as the employees' exclusive representative. The former interpretation leaves room for judicial remedies for breach of the duty of fair representation. The latter makes breach of the duty an unfair labor practice. . . .[40]

The Board has followed the second view that the "duty to bargain collectively includes the duty to represent fairly."[41] The Board reasoned earlier in *Local 1367, Int'l Longshoremen's Ass'n*[42] that Section 8(d)[43] contemplated only lawful agreements and that bargaining agreements which discriminated invidiously were unlawful. Thus, employers and unions were enjoined from entering such contracts. When such unlawful agreements were entered, the contract could not be one envisioned by Section 8(d) nor could the union be said to have bargained in good faith as to either the employees it represents or employers.[44] Professor Sovern and the minority of the Board dispute this view and claim that Section 8(b)3 is simply the counterpart of Section 8(a)5,[45] with a duty only between unions and employers to bargain collectively.[46] This is a more logical conclusion and the history of the act lends it support.[47]

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[40] Cox, *The Duty of Fair Representation*, 2 VILL. L. REV. 151, 172 (1957).

[41] Local 1367, Int'l Longshoremen's Ass'n, 148 N.L.R.B. 897, 899 (1964).

[42] 148 N.L.R.B. 897 (1964).

[43] See note 4 *supra*.

[44] 148 N.L.R.B. at 899-900.

[45] Section (8)5 provides that it shall be an unfair labor practice for an employer: "to refuse to bargain collectively with the representatives of his employees, subject to the provisions of section 159(a) of this title." 61 Stat. 140 (1947), 29 U.S.C. § 158 (a)(5) (1964).

[46] See Sovern, *The National Labor Relations Act and Racial Discrimination*, 62 COLUM. L. REV. 563, 589 (1962).

[47] In addition to the problems raised by this paper, *Rubber Workers* has implications in the area of preemption. Obiter dictum in this case approved the doctrine of giving exclusive jurisdiction to the NLRB where the activity was arguably subject to Sections 7 and 8 of the NLRA. See San Diego Bldg. Trades Council v. Garmon, 359 U.S. 236 (1959). For a discussion of preemption see SOVERN, LEGAL RESTRAINTS ON RACIAL DISCRIMINATION IN EMPLOYMENT 171-74 (1966).

Title VII of the Civil Rights Act of 1964, 78 Stat. 253, 42 U.S.C. §§ 2000(e)(1)-(11) is also beyond the scope of this note but it now serves as an important new weapon in halting discriminatory practices by unions. See Rosen, *The Law and Racial Discrimination in Employment*, 53 CALIF. L. REV. 729 (1965); Sherman, *The Union Duty of Fair Representaton and the Civil Rights Act of 1964*, 49 MINN. L. REV. 771 (1965).

Regardless of the technique[48] used by the majority of the Board to conclude that it is an unfair labor practice to breach the duty of fair representation, the courts should hesitate to accept this result. Under its present course of action, apparently approved in *Rubber Workers*, the Board seems to have established itself as a fair employment practice committee.[49] This development is undesirable for the expansion of the Board's jurisdiction to include fair employment practices has an adverse effect on the primary function of the Board, that of supervising the collective bargaining process. Setting up fair employment standards to be applied by the Board while labor and management engage in collective bargaining would destroy much of the flexibility and perhaps the effectiveness of the collective bargaining process.[50] The extensive supervision required might amount to little less than governmental control of labor-management relations. To those who contend that only the administrative remedy offered by the NLRB is sufficient,[51] one might reply that a potent fair employment practices committee with power to institute court action on a complaint or to give effective remedies for discrimination in employment could achieve the same end as the NLRB without interfering with the present function of the Board.

JAMES NATHAN DUGGINS, JR.

Securities Regulation—Unlisted Tradings: A Vanishing Art?

The historical background of unlisted trading reflects the development of our national securities exchanges. Prior to the evolution of exchanges, local brokers, gathering on street corners, would trade in any available securities.[1] In 1817, the New York Stock Ex-

[48] For methods used by the courts to reach desired results see Blumrosen, *The Worker and Three Phases of Unionism: Administrative and Judicial Control of the Worker-Union Relationship*, 61 MICH. L. REV. 1435, 1445-46 (1963).

[49] Murphy, *The Duty of Fair Representation Under Taft-Hartley*, 30 Mo. L. REV. 373, 385-86 (1965).

[50] Rosen, *The Law and Racial Discrimination in Employment*, 53 CALIF. L. REV. 729, 754 (1965).

[51] See Sovern, *The National Labor Relations Act and Racial Discrimination*, 62 COLUM. L. REV. 563, 609-13 (1962). See also note 13 *supra*.

[1] [1958-1959] 25 SEC. ANN. REP. 71. As early as 1752 American merchants established an "exchange" at Broad Street in New York City, for dealings in meal and water borne produce. At the tip of Wall Street nearest

change, moved indoors and permitted trading in thirty listed stocks by seven member firms and thirteen individual brokers.[2] Any security could be temporarily inserted for trading on the exchange "list" on paying a twenty-five cent fine. A majority vote of members present was required for full listing.[3] In 1869, the newly formed New York Stock Exchange Committee on Stock List[4] promulgated listing requirements and passed on applications for those securities which sought exchange privileges.[5] The strict listing requirements of this committee is an indirect source for modern unlisted trading privileges and practices.

The New York Stock Exchange was primarily a railroad stock market; industrials were considered speculative securities and many could not qualify for listing. When the "Unlisted Department" was created in 1885 securities unable to meet the rigid requirements of the Committee on Stock List were traded on an unlisted basis.[6] The Department, however, was abolished in 1910 pursuant to recommendations made by the Hughes Committee which studied speculation in securities.[7] Today all trading in unlisted securities takes place either on the American Stock exchange or the regional stock exchanges registered under the Securities Exchange Act of 1934.[8] Unlisted trading prior to the enactment of specific legislation consisted of brokers trading in a security, generally without regard to the issuer's wishes, at the request of exchange members. The issuers of these securities were not required to, nor did they undertake to make the informational disclosures required of securities listed on

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the wharves, a more sophisticated market was developed. Here incoming cargoes of European manufactured goods were auctioned off to local merchants. MEEKER, THE WORK OF THE STOCK EXCHANGE at 61 (rev. ed. 1930) [hereinafter cited as MEEKER].

[2] MEEKER 64.

[3] [1958-1959] 25 SEC. ANN. REP. 71-72.

[4] Now the Board of Governors of the New York Stock Exchange.

[5] With the creation of the Securities and Exchange Commission, the requirements for listing on the national securities exchanges were supplemented by those for registration. MEEKER 451. See also [1958-1959] 25 SEC. ANN. REP. 72 n.21.

[6] MEEKER 71.

[7] The title of the committee was the New York Governor's Committee on Speculation in Securities and Commodities; however, it is popularly called the "Hughes Committee." Most stocks in the Unlisted Department in 1910 were industrials and were subsequently admitted to listed status. 2 Loss, SECURITIES REGULATIONS 1133 (2d ed. 1961) [hereinafter cited as Loss].

[8] 48 Stat. 881, 15 U.S.C. §§ 78a-78jj (1964) [hereinafter cited as EXCHANGE ACT].

exchanges although the trading mechanics for listed and unlisted issues were identical. A listed security, for comparison, is admitted to trading on an exchange upon the issuer's application to the exchange on which listing is desired. The issuer must file information generally related to corporate and financial organization as a condition to listing. In contrast, unlisted issues will be traded although investors lack the information available as to listed securities.[9]

A rule of practice on the Philadelphia Stock Exchange in 1876 was that "members may call up the various stocks of any chartered company, whether on the regular list or not."[10] Some regional stock exchanges limited this practice and others completely banned it; however, an amended rule of the same stock exchange in 1932 was adopted in substance by the other regional exchanges.[11] It provided that "no securities could be admitted to unlisted trading which were not listed on the New York Stock Exchange, New York Curb Exchange, as it was then styled, or the Boston Stock Exchange, Pittsburgh Stock Exchange, or Chicago Stock Exchange."[12]

The New York Curb Exchange[13] was the largest market in unlisted securities in both share and dollar volume prior to the Exchange Act; however, the number of securities enjoying unlisted trading privileges was drastically reduced in the years between 1933 and 1934 resulting from an examination conducted by the New York State Attorney General.[14] Findings of speculation and manip-

[9] As a result of an examination by the New York State Attorney General, *infra* note 14, the "Curb" adopted rules which attempted to remedy some or the deficiencies. Unlisted trading privileges for a security would be permitted only if the issuer furnished periodic reports to stockholders at least once a year. These reports must contain balance sheets and statements of profit and loss. Members of the exchange who traded in unlisted securities were required to file an annual report of the issuer of each security as an official copy with the exchange. This copy must be similar to the one issued to the shareholders of the corporation. The "Curb" required each exchange member who desired a security to be traded on an unlisted basis to become a shareholder of that issuer, and all information received by the exchange member in his capacity as a shareholder was to be filed with the exchange. These rules were said to have come too late because the bulk of the securities enjoying unlisted trading privileges were admitted to the "Curb" prior to July 5, 1933, the date that the investigation ended. SEC, REPORT ON TRADING IN UNLISTED SECURITIES UPON EXCHANGES 8-9, 38-47 (1936) [hereinafter cited as REPORT ON TRADING].

[10] [1958-1959] 25 SEC ANN. REP. 72.

[11] *Ibid.*

[12] *Ibid.*

[13] The New York Curb Exchange became known as the American Stock Exchange in 1953.

[14] Unlisted trading privileges for almost one thousand issues were termi-

ulation in unlisted trading prompted Congress to consider legislation.

The original congressional proposals in 1934 were vigorously opposed by the "Curb" and the regional exchanges as they sought immediate abolition of unlisted trading privileges as the solution to the regulatory problem.[15] The exchanges' contended that outright abolition of unlisted trading would result in unwarranted federal regulation.[16] The substance of the retort was four-part. First, the criticized manipulatory practices had been modified after the two year investigation by the New York Attorney General. Second, the exchanges desired to maintain the dollar generating commissions for its member firms and brokers from the existing volume of unlisted trading. Third, regional markets for nationally known issues listed on the New York Stock Exchange were desired where sufficient demand and trading activity was present. And, finally, unlisted trading was an integral and established exchange procedure of long standing.

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nated due to inactivity; nevertheless, the "Curb" market retained its position as the largest market for trading in unlisted securities. Loss, 1133.

[15] One such bill was H.R. 7852 to Provide for the Registration of National Securities Exchanges . . . and to Prevent Inequitable and Unfair Practices on such Exchanges, and for other Purposes. Several eloquent speeches in defense of unlisted trading privileges on the "Curb" were made by its chief executive officer. But E. Burd Grubb, then President of the New York Curb Exchange confessed that:

> In the past, the exchange has itself too freely admitted securities to unlisted trading, particularly . . . where, at the time of admission, no active market in the security existed in the East or in New York. The exchange has recognized these mistakes, and on its own volition, since January 2, 1933, has removed from dealing by reason of inactivity 696 issues of stock and 247 issues of bonds.

Stock Exchange Regulation, *Hearings on H.R. 7852 and H.R. 8720 Before the House Committee on Interstate and Foreign Commerce*, 73rd Cong., 2d Sess. at 389 (1934).

[16] Hon. John Dickenson, Assistant Secretary of Commerce and Chairman of the Interdepartmental Committee on Stock Exchange Regulation, stressed the necessity that

> disciplinary powers over the members and over security issues shall be left primarily for each exchange, each to be responsible to the Federal Stock Exchange Authority for the enforcement of its regulations. If this is not done the moral of the exchange may be destroyed and the Stock Exchange Authority overwhelmed with the policing of alleged violations on all the exchanges of the country.

Id. at 515. Mr. Grubb, President of the "Curb" Exchange, presents a powerful argument for the preservation of the unlisted department on the New York Curb Exchange. *Hearings on S. 84, S. 56 and S. 97 Before the House Committee on Banking and Currency*, 73rd Cong., 1st Sess., pt. 15, at 7115-23 (1934).

The basic objective of the Exchange Act was to compel public disclosure about exchange-traded securities to investors, the exchanges, and the Securities and Exchange Commission. Section 12 of the Exchange Act imposed the additional requirement of registration of securities with the Commission upon the listing requirements of the national exchanges. Subsection (f) however, excepted securities admitted to exchanges with unlisted trading privileges.

In 1934 Congress directed the SEC to study trading in unlisted securities for two years and then to make recommendations. During this time the Commission could extend until July 1, 1936 unlisted trading privileges for securities so traded prior to March 1, 1934, and extend until July 1, 1935 unlisted trading privileges for any security registered on any other exchange prior to March 1, 1934.

The Commission's 1936 report[17] was submitted by Chairman James M. Landis to the Senate Committee on Banking and Currency.[18] The Commission found that the problem was significant. On the sixteen exchanges permitting trading in unlisted securities during 1935, security issues of listed companies exceeded those of unlisted companies by 365 issues; however, the volume of shares of securities traded on an unlisted basis exceeded those of listed securities by 548,514,503 shares. Also, bonds admitted on the same exchanges with unlisted trading privileges had a total face value exceeding that of listed bonds by 675,293,516 dollars.[19] The "Curb," the largest primary market for unlisted trading, had 753 issues of stock, comprising 600,051,527 shares, and 522 bond issues, with a total face value of 6,381,843, 636 dollars, appearing on the exchange with unlisted trading privileges. The Commission concluded that the solution to the problem of regulating unlisted trading did not lie in termination.[20] It observed that issues not admitted to unlisted trading privileges were traded on the over-the-counter market. Many issuers would not attempt to comply with exchange listing requirements but if the issues retained unlisted trading privileges, there would be a great degree of surveillance than if the

[17] REPORT ON TRADING 1.

[18] Trading in Unlisted Securities upon Exchanges, *Hearings on S. 4023 Before the Senate Committee on Banking and Currency*, 74th Cong., 2d Sess. at 1, 3 (1936).

[19] REPORT ON TRADING 4-5.

[20] *Id.* at 7-16.

securities were traded solely on the over-the-counter market where no means were yet devised to register the securities or compel needed disclosures. Thus the imperfect status quo would better serve the investing public than would abolition of the privilege.[21] Furthermore, the Commission found that if unlisted trading were to be terminated, there would be a danger of decline in security values due to section 7(c) of the Exchange Act and Regulation T of the Federal Reserve Board and the smaller exchanges would be endangered.[22] Also, the Commission favored the opportunity to extend the scope of exchange trading in securities for which an exchange market is appropriate and where full information is available.[23] The recommendations contained in the Commission's report[24] were

[21] *Ibid.*
[22] *Ibid.*
[23] *Ibid.*
[24] 1. Subsection (f) of section 12 of the Securities Exchange Act of 1934 should be amended to provide—

a) That unlisted trading privileges on any exchange to which any security had been admitted prior to March 1, 1934, may be continued beyond June 1, 1936, on such terms and conditions as the Commission may by rules and regulations prescribe as necessary or appropriate for the protection of investors or to prevent evasion of the purposes of the Act. No expiration date should be expressly set, but the Commission should continue to have the power to bring about the teminartion of this situation in part or as a whole.

b) That securities the issuer of which has duly registered any security on an exchange pursuant to section 12 may, during the period when such other registration is effective, be admitted to trading on any exchange in accordance with such terms and conditions as the Commission may by rules and regulations prescribe as necessary or appropriate for the protection of investors and to prevent evasion of the Exchange Act.

2. The Commission should thereupon proceed expeditiously to perfect regulations and a program of administration designed to make effective for all securities traded on an unlisted basis on exchanges requirements concerning adequacy of public distribution, degree of local trading activity, minimum information to be supplied, and other requirements necessary to assure a properly functioning market on such exchanges for such securities. Such a program could be put into effect pursuant to section 6(a) section 12(f) and section 19(b) of the Securities Exchange Act of 1934.

3. The existing power of the Commission to bring about adequate reporting by issuers of substantial size, whose securities have a wide public distribution, should be perfected to the end that there be information supplied by these issuers comparable to that now furnished by those who have registered their securities on an exchange. That end being attained, the Commission should then be empowered to prescribe terms and conditions under which the securities of these issuers should be permitted to enjoy an exchange market, where the public interest, not subjected to the sole control of management, would be furthered by the creation of an exchange market.

adopted in substance and, as amended, constituted section 12(f) of the Exchange Act prior to the Securities Acts Amendments of 1964.

Three categories of the securities can be traded on an unlisted basis on national exchanges without registration. The privilege can only be continued or extended by the applicant exchange. Commission approval will follow, if the security meets the requirements of one of the three categories. The first category ("clause 1 securities"), adopting the recommendations of the Commissions study,[25] provides for continuation of unlisted trading in a security if such security was admitted to the applicant exchange prior to March 1, 1934. Clause (1) is a "grandfather clause," as it represents "historical or classical" unlisted trading. The first category is restricted and admissions to it are necessarily unavailable. For the second category (so-called "clause 2 securities"), also recommended by the Commissions study,[26] unlisted trading privileges in any security may be continued or granted by the applicant exchange if the security is also duly listed and registered on any other national securities exchange. There, multiple or dual trading, on more than one national exchange, is available under clause (2).[27] This privilege remains in effect only so long as the security remains both listed and registered on another national securities exchange. The third category ("clause 3 securities") permits unlisted trading privileges for securities which are not listed on any other national exchange if they comply with the registration requirements of either the Exchange Act or the Securities Act of 1933.[28] The theory of this privilege is that the information concerning these issues is "substantially equivalent to that available in respect to a security duly listed and registered on a national securities exchange." Clause (3) is self-policing as the privilege remains effective only so long as the informational disclosures are kept current. The aim of clause (3) was to "enhance the scope of unlisted trading" because securities previously traded solely over-the-counter could now seek an exchange market; hence

REPORT ON TRADING 2-3. See also S. REP. No. 1739, 74th Cong., 2d Sess. (1936); H.R. REP. No. 2601, 74th Cong., 2d Sess. (1936).

[25] See note 24 *supra.*

[26] See note 24 *supra.*

[27] "The terms 'multiple' and 'dual' are used more or less interchangeably in this context, the former, of course, implying that the phenomenon of 'dual' trading may extend to several different markets." SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS pt. II, at 809 (1963).

[28] 48 Stat. 74 (1933), as amended 15 U.S.C. §§ 77a-77aa (1964).

it represented a compromise between the exchange and the over-the-counter market.[29] It was found that the "public interest would be served by exchange trading although the issuer did not itself seek it.[30] Clause (3) ties in with section 15(d) of the Exchange Act since it extended unlisted trading privileges to securities traded on the over-the-counter market. Through this section, Congress perfected the Commission's power to bring about reliable disclosures of widely distributed securities generally unavailable to the public prior to section 15(d).[31]

The general policy of subsection 12(f) is that the Commission shall continue or extend unlisted trading privileges by approving only those applications which are "necessary or appropriate in the public interest or for the protection of investors." When approval of applications to extend unlisted trading privileges is sought pursuant to clauses (2) and (3), a hearing is held by the Commission at which it is determined whether the general policy of Subsection 12(f) is met. The applicant exchange must demonstrate that in the "vicinity of the exchange"[32] there is sufficiently widespread public distribution and trading activity[33] in the issuer's securities that un-

[29] Loss 1134.

[30] REPORT ON TRADING 25.

[31] *Hearings on S. 4023 Before the House Committee on Interstate and Foreign Commerce*, 74th Cong., 2d Sess. at 4 (1936).

[32] The concept of "vicinity of the exchange" has resulted in a multitude of litigation by the various securities exchanges. The interpretation originally given in the Matter of Applications by the New York Curb Exchange, 3 S.E.C. 81 (1938) was later adhered to. There, the Commission concludes: "that the claim of the Curb Exchange to a vicinity including the whole United States is not sustained. . . . Rather, we interpret 'vicinity' to mean the particular geographical section or sections in which a particular exchange ranks as the, or one of the, national exchanges to which investors would look for an exchange market in the securities for which unlisted trading is sought." *Id.* at 85. The Commission has consistently held, as did the Third Circuit in National Ass'n of Securities Dealers v. S.E.C., 143 F.2d 62 (3d Cir. 1944), that the vicinity of the New York Curb Exchange is Massachusetts, Rhode Island, Connecticut, New York, New Jersey, Pennsylvania and Ohio with respect to certain bonds. Compare In the Matter of Application by the Baltimore Stock Exchange, 12 S.E.C. 516 (1942) (State of Maryland held the vicinity of the Baltimore Exchange); In the Matter of Application by the Boston Stock Exchange, 12 S.E.C. 658 (1943) (vicinity of the applicant exchange held all of New England except Fairfield County, Conn.); In the Matter of Application by the Chicago Stock Exchange, 9 S.E.C. 805 (1941)(State of Illinois held vicinity of the Chicago Stock Exchange). The vicinity of substantially every stock exchange has been litigated. For a complete list of the decisions and a review of their holdings, see 2 CCH FED. SEC. L. REP. ¶ 23, 241 (1966). See also Loss 1136-1137.

[33] In the Matter of the Boston Stock Exchange, 3 S.E.C. 691 (1938).

listed trading privileges for such securities is "necessary or appropriate in the public interest or for the protection of investors." The Commission is neutral in this determination and is in no way influenced by the fact that an exchange files under clause (2) (because such security also enjoys listed and registered trading status on another national exchange) or clause (3) (where an issue has traded on the over-the-counter market). The SEC criteria do not favor clause (2) over clause (3) applicants or vice versa; however, the ultimate determination to be made is "whether under the statutory standards a market on the particular exchange is an appropriate medium for trading in the particular security."[34]

An application under clause (3) will be granted only upon terms and conditions which will subject the issuer, its officers and directors, and any beneficial owner of more than ten percent of the security to duties substantially equivalent to those applicable to securities listed and registered on a national exchange. For example, if a certain security is subject to a regulatory standard other than the Exchange Act, the periodic reporting, proxy solicitation and insider trading provisions of that other statute would be compared to sections 13, 14 and 16 of the Exchange Act to determine whether the substantially equivalent test is met. This requirement is best illustrated by *In the Matter of Applications by the New York Curb Exchange for Unlisted Trading Privileges in American Gas and Electric Company, Public Service Company of Colorado and The Washington Water Power Company.*[35] Here the "Curb" sought

Here, an application for extension of unlisted trading privileges under subsection 12(f), Clause (2) of the Exchange Act was granted. Of the 1,500,000 shares that were outstanding, 245,100 or approximately 16 2/3% were held by 3,299 shareholders in New England. For the twelve months ended on April 30, 1938 the volume of trading in the security was 7,325 shares as contrasted to the volume in 1937 of 11,309 shares. This volume was compared to that in the same security on the New York Stock Exchange which amounted to 514,000 shares for the same 1937 period. The Commission found that there exists sufficient public distribution and trading activity in the vicinity of the applicant exchange to render the extension of unlisted trading privileges.

[34] Loss 1135-1136.

[35] In the Matter of Applications by the New York Curb Exchange, 7 S.E.C. 672 (1940). The securities represented were three series of multi-interest-bearing sinking fund debentures and cumulative preferred stock of American Gas and Electric Company, mortgage bonds and sinking fund debentures of Public Service Company of Colorado, and mortgage bonds of The Washington Water Power Company. Later it was agreed between the Commission and counsel for the New York Curb Exchange that first

SEC approval under section 12(f)(3) of the Exchange Act of unlisted trading privileges of securities of an issuer subject to section 15(d) of the Exchange Act and registered under the Public Utilities Holding Company Act of 1935.[36] Although the bonds and debentures would not normally be subject to the proxy solicitation requirements of section 14 of the Exchange Act, the companies were already subject to equivalent proxy regulation under the Holding Company Act.[37] Only the preferred stock of American Gas was an equity security as defined in section 3(a)(11) of the Exchange Act. Section 16 of the Exchange Act would be inapplicable to transactions by the officers, directors and beneficial holders of more than ten per cent of the bonds and debentures. The Holding Company Act by section 17(a) and (b) imposed restrictions upon officers and directors similar to those of sections 16(a) and (b) of the Exchange Act. However, section 16(c) of the Exchange Act did not have a regulatory counterpart in the Holding Company Act, so that short term trading as well as short selling of equity securities by "insiders" was not regulated. Counsel for the "Curb" produced a letter from American Gas which stated that the corporate records disclosed that no shareholder held in excess of ten per cent of the preferred stock. Furthermore, the manager of the "Curb's" Unlisted Trading Division testified that short selling in the preferred stock could not readily be anticipated due to the quality investment grade of the stock and the market price; this indicated that the security was selling at a substantial premium. The Commission found that since the investment grade of the preferred stock negated a potential for speculative short selling by "insiders" and since the corporate records disclosed no shareholders owning more than ten per cent of the equity security, the applications for extension should be approved.[38]

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and refunding mortgage bonds in Pennsylvania Electric Company be included as a part of the applications.

[36] 49 Stat. 838, 15 U.S.C. §§ 79-792-6.

[37] In the Matter of Applications by the New York Curb Exchange, 7 S.E.C. 672, 675 (1940).

[38] It is interesting to note that when the Curb attempted to procure an agreement from the issuer, American Gas and Electric Company, to the effect that its officers and directors would not sell its preferred stock short, the issuer responded that "it would not in any way associate itself or become obligated in connection with the application of the New York Curb Exchange for the extension of unlisted trading privileges to this preferred stock." *Id.* at 677.

The Commission may suspend the privilege of unlisted trading for a period not exceeding twelve months if for the protection of investors. If an exchange seeks to continue or extend unlisted trading privileges under clause (1) for a security which its issuer has withdrawn from exchange listing, the Commission may terminate trading in that security unless the issuer can establish that de-listing was not designed to evade the policies of subsection 12(f) of the Exchange Act.

Prior to the Exchange Act brokers traded in securities not listed upon exchanges without regard to the issuer's wishes. The Exchange Act responded by providing that an issuer, market making broker or dealer or anyone having a bona fide interest in terminating or suspending a security's unlisted trading privileges may apply to the SEC for an order to that effect.[39] The Commission may also on its own motion suspend or terminate such privileges on finding this is necessary for investor protection.[40] General objection to exchange trading, inadequate public distribution of the security in the "vicinity of the exchange" and insufficient trading activity are specifically assigned as reasons for suspension or termination.

When an applicant exchange seeks unlisted trading privileges under clause (1) for a security which has delisted from a national exchange,[41] or when an application is filed under clauses (2) and (3),[42] or whenever the Commission or others would suspend or terminate unlisted trading in a security,[43] appropriate notice and opportunity for a hearing must be given to parties directly affected by the Commission not later than ten days prior to the hearing.

Securities for which unlisted trading privileges have been continued or extended are deemed to be registered on a national securities exchange and the rules of that exchange will be subject to review by the Commission by virtue of its power under section 19(b) of the Exchange Act.[44] The Commission may, "if in the public interest

[39] 2 CCH FED. SEC. L. REP. ¶ 30, 966 (1965).
[40] EXCHANGE ACT § 12(f)(3).
[41] EXCHANGE ACT § 12(f)(4).
[42] EXCHANGE ACT § 12(f)(2).
[43] EXCHANGE ACT § 12(f)(3-4).
[44] This section provides that the Commission may make a written request to a national securities exchange suggesting that the exchange effect a change in its rules and procedures. If the changes suggested by the Commission are not effectuated and the Commission feels that the changes are necessary to insure fair dealings in securities traded on the exchanges, it

or for the protection of investors," either unconditionally, upon specified terms and conditions, or for stated periods exempt such securities from the operation of any provisions of section 13, 14 or 16 of the Exchange Act.[45]

The Securities Acts amendments of 1964 extended registration and the requirements formerly applicable only to securities listed on national securities exchanges under the Exchange Act, to many securities traded on the over-the-counter market. As for unlisted securities, the 1964 amendments modified clause (1), left substantially unchanged clause (2) and eliminated clause (3). These changes made by the amendments reflect the recommendations made by the Report of the Special Study of Securities Markets of the Securities and Exchange Commission.[46]

Clause (1) was an anomaly and remains so. Although section 12(f)(6) declares that securities admitted to unlisted trading privileges shall be deemed registered, clause (1) securities are not so at all. These securities admitted to trading on a national exchange on an unlisted basis prior to March 1, 1934 may today continue to be traded on that basis with Commission approval upon application by the exchange which originally admitted the security.[47] With the class limited by statute and continuation of the privilege resting in the Commission's discretion, time alone by means of "retirement, redemption, liquidation, reorganization, or the transition of seasoned securities to a listed status"[48] will gradually eliminate clause (1) securities. Congress found no reason to change the general pattern in respect to clause (1) securities even though pursuant to law disclosures provided for in sections 13, 14 and 16 of the Exchange Act need not be made. Furthermore, the Special Study in its 1963 report noted that if a clause (1) security was required either to register or make disclosures substantially equivalent to securities listed and registered on national exchanges pursuant to sections 12(g) or 15(d) of the Exchange Act, the initial clause (1) exemp-

may, after a hearing, supplement the rules of the exchange by rules, regulations or by order.

[45] Section 13 is concerned with periodic reports; section 14 with proxy solicitation requirements; and section 16 deals with duties in regard to officers, directors and principal shareholders of issuers.

[46] SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS pt. II, at 809 (1963).

[47] EXCHANGE ACT § 12(f)(1)(A).

[48] H.R. REP. No. 2601, 74th Cong., 2d Sess. 2-3 (1936).

tion from sections 13, 14 and 16 of the Exchange Act would be meaningless.[49] This is because the disclosures made under sections 12(g) and 15(d)[50] of the Exchange Act are substantially equivalent to those under sections 13, 14 and 16. The unfortunate anomaly of clause (1) securities still exists, but only in the minutest detail.

The amendments left clause (2) securities substantially unchanged. The reason for maintaining the status quo can be explained by statutory interpretation. The statute provides that unlisted trading privileges on a national exchange may be extended "to any security duly listed and registered on any other national securities exchange."[51] If the Commission has available section 13, 14 and 16 disclosures, by virtue of the fact that the security admitted to unlisted trading privileges is also listed and registered on another national exchange, the information need not be duplicated. However, if admission to the privilege of unlisted trading was originally predicated upon the fact that a security was listed and registered on another national exchange and delisting subsequently follows, unlisted trading privileges on all exchanges must terminate.

The Commission in its 1936 report emphasized the importance of securing registration of securities traded on the over-the-counter market. If listed and registered securities are subject to the provisions of sections 13, 14 and 16 of the Exchange Act, it is arguable that securities traded over-the-counter should be as well as they have no exchange surveillance. Prior to the amendments few exchange applicants filed pursuant to clause (3) and fewer were granted. It was the least used and legally the most troublesome of the three clauses. By extending sections 13, 14 and 16 of the Exchange Act

[49] 17 C.F.R. § 240.12f-4 (1964).

[50] Section 15(d) of the Exchange Act, as amended, provides that the obligation of an issuer to file periodic reports is suspended if, and so long as, the issuer has a class of securities registered pursuant to section 12 of the Exchange Act. Section 12(g) of the Exchange Act requires an issuer of securities traded on the over-the-counter market, with total assets exceeding 1,000,000 dollars and a class of non-exempt equity security held of record by 750 or more persons to be reduced to 500 after July 1, 1966, to register such security by filing a registration statement with the Commission within 120 days after the last day of its first fiscal year ended after July 1, 1964 on which it meets the above standards. The revision of section 15(d) and the addition of section 12(g) necessitated certain amendments to Rule 12f-4, which provides exemptions from sections 13, 14 and 16 of the Exchange Act for issuers having securities admitted only to unlisted trading privileges. See SEC Exchange Act Release No. 34-7491 (1965).

[51] EXCHANGE ACT § 12(f)(1)(B).

to cover certain issuers whose securities are not listed on a national exchange by means of sections 12(g) and 15(d), it would follow that those securities traded on the over-the-counter market would immediately qualify for unlisted trading privileges under clause (3). Numerous applications would be filed by exchanges seeking to extend unlisted trading privileges for these securities; hence, clause (3) was deleted by the amendments.[52] The extension of the registration requirements of the Exchange Act to 12(g) over-the-counter issuers not only was consistent with the policy of the Exchange Act but by subjecting large over-the-counter issuers to the same requirements as issuers of listed securities, it eliminated many of the immunities formerly enjoyed by over-the-counter securities and thus made formal listing more attractive.

The amendments eliminate the criteria of public distribution and trading activity in the "vicinity of the exchange" in determining whether or not to extend or continue unlisted trading privileges although these remain factors to weigh in the Commission's decision. The main question now is whether or not the privilege is "necessary or appropriate in the public interest or for the protection of investors."[53]

The 1964 amendments delete the provision requiring differentiation between listed and unlisted security quotations,[54] because the Commission's authority under the Exchange Act could not be extended to enjoin "outsiders" from withholding the "U" and "L" designations which were required by law when an exchange published the transactions and quotations.[55] In determining if the public interest is best served by suspending, terminating, continuing and extending unlisted trading privileges, the Commission is provided leeway by the liberalized investor protection approach provided for by the amendments.

I. Rule 12(f)-1: Applications for Permission to Extend Unlisted Trading Privileges

To extend unlisted trading privileges under subsection 12(f)(1) of the Exchange Act,[56] an application executed by a duly authorized

[52] S. Rep. No. 354 88th Cong., 1st Sess. 59 (1963).
[53] Exchange Act section 12(f) (prior to 1964 Amendments) second paragraph.
[54] S. Rep. No. 354, 88 Cong., 1st Sess. 59 (1963).
[55] See note 42 *supra*.
[56] 17 C.F.R. § 240.12f-1 (1964).

officer of the exchange must be filed with the Commission. It must identify the issuer as well as the security and contain data, and its source, in respect to public distribution and trading volume in the security in the "vicinity of the exchange" for a specified period preceding the date of the application. The Commission also requires that other information "pertinent to the question of whether the continuation or extension of unlisted trading privileges in such security is necessary or appropriate in the public interest or for the protection of investors" be included in the application.

II. Rule 12(f): Changes in Securities Admitted to Unlisted Trading Privileges

When there is a change in a clause (2) security,[57] it shall be considered the same security admitted to unlisted trading privileges if, under Regulation 12B[58] and Regulation 12D,[59] its issuer need not file a new application for registration with the SEC to continue listed registered status on a national securities[60] exchange.

The following Illustrations will be utilized to clarify the remaining provisions of this rule:

Illustration 1: XYZ Corp.'s charter authorizes 1,000,000 shares of five dollar par value Class "B" common stock of which 100,000 are outstanding. On January 1, 1966, XYZ's securities have been admitted to unlisted trading privileges on a national exchange. The securities do not enjoy trading privileges on any other national exchange. The corporation has paid a quarterly dividend of twenty-five cents per share for the past two years. On July 1, 1966, the majority of the Board of Directors, in accordance with the provisions in the by-laws, resolves the following:

A) Due to dissatisfaction with the corporate name, XYZ changes its name to ABC Corp., and changes the name of the class "B" common stock to class "A" common.
B) Due to substantial non-recurring losses sustained in the preceding calendar year, the quarterly dividend is reduced to ten cents per share.
C) Due to contemplated expansion, the par value of class "B"

[57] 17 C.F.R. § 240.12f-2 (1964).
[58] 17 C.F.R. § 240.12B (1964). These rules are concerned with registration and reporting.
[59] 17 C.F.R. § 240.12D (1964). These rules specify the effectiveness of registration and exchange certificates.
[60] 17 C.F.R. § 240.12f-2(a)(1) (1964).

common stock (now class "A") is reduced from five to 2.50 dollars per share and the number of shares authorized is correspondingly increased to 2,000,000 shares.

The Secretary of XYZ Corp. notifies the national exchange on which the securities are enjoying unlisted trading privileges, and the exchange notifies the Commission of such changes on Form 27. XYZ's securities are deemed the same securities theretofore admitted to unlisted trading privileges on such national exchange.[61]

Illustration 2. Assume all facts in Illustration 1 are true, but the Board also resolves that:

D) The newly named ABC Corp. and DEF Corporation will consolidate on July 30, 1966 into the ABF Corporation.
E) In honor of the Chairman of the Board, on July 8, 1966, 125,000 shares will be issued as a gift to him for fifty years of service to ABC Corp.

The exchange and the Commission are notified of the changes as in Illustration 1, but in addition the exchange, through a duly qualified officer, files an application with the Commission which identifies the issuer and the security and gives a brief description of each change in the security together with a copy of all the written matter submitted to shareholders relating to the changes. If the Commission determines that after the resolved changes are completed the security is substantially equivalent to that which was originally granted unlisted trading privileges, the security shall be deemed the same, and unlisted trading privileges in it may continue on the applicant exchange. The Commission should find that the security is the same in each illustration.[62]

III. Rule 12(f)-3: Termination or Suspension of Unlisted Trading Privileges

The applicant desiring suspension or termination of unlisted trading privileges in a security traded on a national exchange must

[61] 17 C.F.R. § 240.12f-2(a)(2)(A)(B)(C) (1964).
[62] 17 C.F.R. § 240.12f-2(a)(3), (b) (1964). Note that a major change in the capitalization of the issuer can be accomplished by merger, consolidation, or acquisition of assets or securities as well as a similar transaction. A sale of securities for cash, a stock dividend or stock split is not included in that category; however, where the number of shares of the issuer's outstanding stock has been increased by more that 100% within any twelve consecutive calendar months, this will be considered a major change in capitalization. Also, if an application is filed pursuant to Rule 17 C.F.R.

identify itself, the issuer, and the security and must state its interest in the security and reasons for suspension or termination. Information, and its source, regarding the character and volume of trading activity and public distribution of the security for specified periods must also be furnished.[63] Furthermore, if the exchange desires to suspend or terminate unlisted trading privileges in such security, it may do so according to its own rules after which it must notify the Commission promptly on Form 28 as to the action it has taken.

IV. Rule 12(f)-4: Exemption of Securities Admitted to Unlisted Trading Privileges From Sections 13, 14 and 16

Section 12(f)(6) of the Exchange Act provides that a security admitted to unlisted trading privileges on a national exchange shall be deemed registered, but the Commission may exempt any security from the operation of section 13, providing for periodic disclosures of the issuer's financial and managerial operations, section 14, relating to proxy solicitation requirements, and section 16, protecting against "insider" dealings in the issuer's securities.

Rule 12(f)-4(a) exempts a security traded on an unlisted basis from the requirements of section 13 of the Exchange Act unless it falls within either of two categories. The first group includes the original security for which the privilege has been granted or another security of the same issuer listed and registered on another national exchange, or registered under section 12(g) of the Exchange Act. The second encompasses those securities which, but for the "deemed-registered" provision of section 12(f)(6), would be required to file data under section 15(d) of the Exchange Act.

Rule 12(f)-4(b) provides that clause (2) securities or those required to register under section 12(g) of the Exchange Act are not exempt from section 14, but all other securities for which unlisted trading privileges have been extended or continued are so exempt.

Rule 12(f)-4(c)(1) provides an exemption from section 16 of the Exchange Act in respect to equity securities for which unlisted trading privileges have been continued or extended.[64] Equity securi-

§ 240.12f-2(b) (1964), Form 27 of the Securities and Exchange Commission need not be filed.

[63] 17 C.F.R. § 240.12f-3 (1964).

[64] 17 C.F.R. § 240.12f-4 (1964).

ties in the first category, however, are not exempt. "Any equity security for which unlisted trading privileges on any national securities exchange have been continued or extended pursuant to section 12(f) of the Act and which is not listed and registered on any other such exchange or registered pursuant to section 12(g) of the Act shall be exempt from section 16 of the Act insofar as that section would otherwise apply to any person who is directly or indirectly the beneficial owner of more than 10 per cent of such security, unless another equity security of the issuer of such unlisted security is so listed or registered and such beneficial owner is a director or officer of such issuer or directly or indirectly the beneficial owner of more than 10 per cent of any such listed or registered security."[65, 66]

V. Rule 12f-6: Continuance of Unlisted Trading Privileges in Merger Exchanges:[67]

If a clause (1) security is traded on a national exchange which is absorbed by another, the privilege continues without further order of the Commission if the vicinity of the absorbed exchange includes that of the surviving exchanges. The same rule is applicable to clause (2) and (3) securities. The vicinity of the exchange is determined by the United States Bureau of the Census.[68]

The statutes have been analyzed, the regulations set forth and the effects of the amendments have been noted. What is the future of unlisted trading privileges? Clause (1) securities admitted to unlisted trading privileges prior to July 1, 1964 may continue to enjoy the privilege.[69] The repeal of clause (3) does not in any way affect the extension of unlisted trading privileges to a security already listed and registered on another national exchange;[70] in fact, the

[65] 17 C.F.R. § 240.12f-4(c)(2) (1964). See also SEC Exchange Act Release No. 34-7491 (1965), amended paragraphs (a), (b), and (c) of Rule 12f-4, and added paragraph (d) which provides, "Any reference in this rule to a security registered pursuant to section 12(g) of the Act shall include, and any reference to a security not so registered shall exclude, any security as to which a registration statement pursuant to such section is at the time required to be effective."

[66] 13 Fed. Reg. 8195 (1948) (repealed September 1, 1964, by SEC Exchange Act Release No. 34-7408 (1964).

[67] 17 C.F.R. § 240.12f-6 (1964).

[68] 17 C.F.R. § 240.12f-7 (1964). See also SEC Exchange Act Release No. 34-7397 (1964). This rule served a transitional purpose. It is of no importance today.

[69] Exchange Act § 12(f)(1)(A).

[70] Exchange Act § 12(f)(1)(B).

amendments proscribe admission to the privilege if the issuer's securities are not listed and registered on at least one other national exchange.[71]

Commission surveys for the preceding four years[72] validated the SEC's forecast in its 1936 report that clause (1) securities would gradually diminish in number and importance. Some issuers have chosen to list their securities on national exchanges, and others whose securities previously enjoyed the privilege have liquidated, merged or in other ways terminated an unlisted trading status which at one time existed. Today almost all trading in clause (1) securities is conducted on the American Stock Exchange (formerly the "Curb").[73]

The future of unlisted trading lies in clause (2) securities which are registered and listed on one national securities exchange but enjoy unlisted trading privileges on another. All securities traded on the New York Stock Exchange are listed only after approval by the Exchange's Board of Governors. No securities traded on any other exchange may be traded on an unlisted basis on the New York Stock Exchange. However, securities listed and registered on the "Big Board" may be traded on an unlisted basis on regional securities exchanges. The American Stock Exchange, on the other hand, does not trade in securities listed and registered on the New York Stock Exchange, under a firmly established policy. The American Exchange is the home of clause (1) securities and many issues of old established nationally known securities still enjoy exchange trading there without complying with the registration requirements of section 12 of the Exchange Act.

Although the American Exchange does not trade in securities listed and registered on the "Big Board," it does trade in issues listed and registered on the various regional exchanges. However, trading volume in clause (2) securities on the American Exchange is apt to remain relatively constant, if not decrease. The reason stems mainly from the exchange's policy decision. Moderate size issuers considering listing on a national exchange will tend to prefer the New York Stock Exchange. The "Big Board" is the largest national exchange and is located closest to the major sources of

[71] *Ibid.*
[72] See generally [1961-1965] 28-31 SEC. ANN. REP.
[73] See Chart I *supra.*

world capital. The regional exchanges have a self-imposed monopoly on trading in clause (2) securities listed and registered on the "Big Board."

Many smaller issuers will list their securities only on a regional exchange because they are known only in the exchange vicinity. If the American Exchange trades only in the latter class of securities on an unlisted basis, most share volume of clause (2) securities will be transacted on the regional exchanges. The liquidity of regionally listed issues on the American Exchange will most probably be less impressive than that of nationally traded issues also traded on regional exchanges. This is because the "float" of outstanding securities of an issuer listed on the "Big Board" proportionally exceeds that of securities listed on regional exchanges, and also because the supply and demand factor would be similar to that of the New York Stock Exchange. It seems clear that the future of unlisted trading lies on the regional securities exchanges where securities listed and registered on the New York and American Stock Exchanges can be traded on an unlisted basis pursuant to clause (2).

Statistics for the calendar years ending June 30, 1962 through 1965,[74] indicate a positive increase in clause (2) securities. Seven regional exchanges have more stocks traded under clause (2), and four have a greater volume of shares traded in this category than the American Exchange. In view of the trends reported by the Commission, it is not inconceivable that in the next two decades no clause (2) securities will be traded on the American Exchange.[75] However, the American Exchange will continue to be the home of unlisted trading in "historical" clause (1) securities, but over the years this class will be eliminated.

The evidence to date indicates that within the next two decades all clause (2) trading will be transacted on the regional exchanges. Aside from the statistically demonstrable trends, this statement finds further support in the strong policy of the American Exchange to encourage full listing.

Even so, the regional exchanges favor multiple trading. The President of the San Francisco Stock Exchange recently declared[76] that:

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[74] See note 72 *supra.*

[75] See Chart II *infra.*

[76] The statement was presented before the Senate Committee on Banking and Currency of the 84th Congress. See note 77 *infra.*

> " '[T]rading in dual issues by our exchange does not constitute a duplication of trading on the New York Stock Exchange, but on the contrary provides an important supplementary market which has proven to be in the public interest. Members of our exchange generate orders in these securities for the very reason that they are traded here. If they were not listed locally, member firms might well recommend to their clients other securities of equal value that were listed locally rather than those traded only in Eastern markets.' "[77]

A similar view is taken by the Vice President and Secretary of the Midwest Stock Exchange.

There is no doubt that dual trading will benefit the regional exchanges; in fact, the increase in dual trading activity in the past few years has raised internal standards of supervision of trading on the regional exchanges, and undoubtedly the regional exchanges will perfect and enforce their rules and regulations so as to minimize the opportunity for manipulation in unlisted securities.

Although the volume of trading in unlisted stocks and bonds is decreasing yearly on the American Stock Exchange, unlisted trading on the regional securities exchanges is only beginning to exhibit its importance. Clearly the practice of unlisted trading is not a vanishing art, but rather a mushrooming innovation presently emerging on the regional exchanges which might cause regulatory concern to the SEC in the years ahead.

STEVEN H. LEVENHERZ

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[77] WALTER, THE ROLE OF REGIONAL SECURITY EXCHANGES 31 (1957). See also, *Stock Market Study Hearings*, 84th Cong., 1st Sess. 241 (1955); *Hearings Before the Senate Committee on Banking and Currency*, 84th Cong., 1st Sess. at 241 (1955).

CHART I
PART I
NUMBER OF STOCKS ON THE EXCHANGES IN THE VARIOUS UNLISTED CATEGORIES AS OF JUNE 30, 1965[1]

Exchanges	*Unlisted Only*[2]		*Listed and Registered on Another Exchange*		
	Clause (1)	*Clause (3)*	*Clause (1)*	*Clause (2)*	*Clauses*[3] *(3)*
American	113	2	15	3	1
Boston	0	0	121	248	0
Chicago Board of Trade	0	0	3	0	0
Cincinnati	0	0	0	136	0
Detroit	0	0	13	187	0
Honolulu	13	0	0	0	0
Midwest	0	0	0	125	0
Pacific Coast	1	0	55	171	0
Phila-Balt-Washington	2	0	201	297	0
Pittsburgh	0	0	16	65	0
Salt Lake	2	0	0	0	1
Spokane	3	0	1	2	0
Wheeling[4]	0	0	0	0	0
TOTAL[5]	134	2	425	1,234	2

[1]SEC, 31st Ann. Rep., Table 9. 171 (1965). The categories used reflect Clauses (1), (2), and (3) of section 12 (f) of the Exchange Act, as in effect prior to the 1964 Amendments.
[2]None of these issues have listed stocks on domestic exchanges.
[3]These have become listed and registered on other national securities exchanges subsequent to the time they were admittted to unlisted trading privileges.
[4]The Wheeling Stock Exchange dissolved and terminated its exemption from registration as a national securities exchange effective 4/30/65.
[5]Duplication of issues among exchanges bring the figures to more than the actual number of issues involved.

CHART I
PART II
UNLISTED SHARE VOLUMES ON THE EXCHANGES— CALENDAR YEAR 1964

Exchanges	*Unlisted Only*		*Listed and Registered on Another Exchange*		
	Clause (1)	*Clause (3)*	*Clause (1)*	*Clause (2)*	*Clause (3)*
American	23,574,054	16,940	5,466,660	4,032,000	27,510
Boston	0	0	2,190,933	2,221,728	0
Chicago Board of Trade	0	0	0	0	0
Cincinnati	0		0	602,531	0
Detroit	0	0	548,802	7,331,663	0
Honolulu	65,180	0	0	0	0
Midwest	0	0	0	16,400,855	0
Pacific Coast	23,429	0	5,543,927	10,344,890	0
Phila.-Balt.-Wash.	0		6,010,126	6,585,844	0
Pittsburgh	0	0	243,426	304,469	
Salt Lake	406		0	0	0
Spokane	841,300	0	9,937	60,513	0
Wheeling	0	0	0	991	0
TOTAL	24,504,369	16,940	20,013,811	47,885,524	27,510

CHART II

TRADING VOLUME OF FULLY LISTED ISSUES COMPARED TO THAT OF UNLISTED ISSUES[1]

In previous reports attention was called to the fact that since the enactment of the Securities Exchange Act of 1934, with its prohibitions and restrictions against the admission of new securities to unlisted trading, the volume of trading in fully listed securities (particularly stocks) is coming to represent an ever-increasing proportion of the total trading volume of the Exchange. This trend continued in 1965 as evidenced by the following table, from which it will be noted that the percentage of trading volume in fully listed stock issues on the Exchange in 1965 amounted to 92.82%, compared with 91.15% in 1964.

	VOLUME OF TRADING					
STOCKS	*Listed*		*Unlisted*		*Total*	
1965	495,858,689	(92.82%)	38,363,310	(7.18%)	534,221,999	(100%)
1964	341,066,678	(91.15%)	33,117,164	(8.85%)	374,183,842	(100%)
1963	286,826,110	(90.56%)	29,908,952	(9.44%)	316,735,062	(100%)
1962	276,090,210	(89.47%)	32,519,094	(10.53%)	308,609,304	(100%)
1961	436,162,950	(89.22%)	52,668,087	(10.78%)	488,831,037	(100%)
1960	249,971,471	(87.39%)	36,068,511	(12.61%)	286,039,982	(100%)
1959	328,560,667	(87.84%)	45,497,879	(12.16%)	374,058,546	(100%)
1958	204,119,378	(84.92%)	36,239,146	(15.08%)	240,368,524	(100%)
1957	181,073,796	(84.61%)	32,937,770	(15.39%)	214,011,566	(100%)
1956	189,422,438	(82.99%)	38,808,609	(17.01%)	228,231,047	(100%)
1955	181,840,462	(79.42%)	47,115,853	(20.58%)	228,956,315	(100%)
1950	61,262,801	(56.83%)	46,529,539	(43.17%)	107,792,340	(100%)
1945	72,376,565	(50.50%)	70,932,727	(49.50%)	143,309,292	(100%)
1941	18,098,385	(52.22%)	16,557,969	(47.78%)	34,656,354	(100%)
1936	50,219,304	(37.50%)	83,691,128	(62.50%)	133,910,432	(100%)
BONDS						
1965	$141,748,000	(96.48%)	$5,179,000	(3.52%)	$146,927,000	(100%)
1964	98,246,000	(94.57%)	5,640,000	(5.43%)	103,886,000	(100%)
1963	71,662,000	(92.71%)	5,631,000	(7.29%)	77,293,000	(100%)
1962	72,173,000	(93.12%)	5,335,000	(6.88%)	77,508,000	(100%)
1961	49,127,000	(80.03%)	6,057,000	(10.97%)	55,184,000	(100%)
1960	27,003,000	(82.65%)	5,667,000	(17.35%)	32,670,000	(100%)
1959	25,563,000	(79.46%)	6,608,000	(20.54%)	32,171,000	(100%)
1958	15,533,000	(68.16%)	7,257,000	(31.84%)	22,790,000	(100%)
1957	10,536,000	(63.71%)	6,002,000	(36.29%)	16,538,000	(100%)
1956	13,534,000	(60.74%)	8,748,000	(39.26%)	22,282,000	(100%)
1955	15,911,000	(45.04%)	19,419,000	(54.96%)	35,330,000	(100%)
1950	12,029,000	(25.30%)	35,520,000	(74.70%)	47,549,000	(100%)
1945	11,316,000	(6.76%)	156,017,000	(93.24%)	167,333,000	(100%)
1941	23,726,000	(9.50%)	225,999,000	(90.50%)	249,725,000	(100%)
1936	50,679,000	(6.10%)	772,506,000	(93.90%)	823,185,000	(100%)

[1]This is a reproduction of American Stock Exchange *Annual Statistical Review 1965*, (February 25, 1966) p. 24.

Taxation—Business Expenses Deduction of Clayton Act Treble Damages

For many years the Commissioner of Internal Revenue has denied, on grounds of public policy, the deduction under section 162 of the Internal Revenue Code of fines and penalties arising from business activities.[1] The Commissioner seemingly reversed himself, however, when he announced in Revenue Ruling 64-224 that treble damages paid by manufacturers to their customers in settlement of suits brought under section 4 of the Clayton Act could be deducted as a business expense.[2]

In the recent case of *Commissioner v. Tellier*[3] the United States Supreme Court laid down a three part test for non-deductibility that throws doubt on the correctness of Revenue Ruling 64-224. In

[1] 4A MERTONS, LAW OF FEDERAL INCOME TAXATION §§ 25.50-53 (1966). Section 162(a) allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . ." The early cases disallowing deductions for fines and penalties followed a theory that no such expenses were "ordinary and necessary." *E.g.*, Burroughs Bldg. Material Co. v. Commissioner, 47 F.2d 178, 180 (2d Cir. 1931). Generally, however, "ordinary and necessary" requires only that an expense be directly related to a business and considered "helpful" within the trade as a means of pursuing that business. Commissioner v. Heininger, 320 U.S. 467, 471 (1943); Welch v. Helvering, 290 U.S. 111, 113-14 (1933); Kornhauser v. United States, 276 U.S. 145, 153 (1928). More recent cases attempt to determine if the expense is ordinary and necessary apart from the question of whether allowance of the deduction would be against public policy. Coed Records, Inc., 47 T.C. No. 41, (1967); Tellier v. Commissioner, 342 F.2d 690, 694 (1965), *aff'd*, 383 U.S. 687 (1966). Separation of the two issues is desirable because it focuses the attention of the court on the policy which is said to require disallowance rather than on the wrongful conduct of the taxpayer. Where the activity that gives rise to a fine is one that is uncommon in a trade, it would still be appropriate to deny a deduction on the grounds that it is not "ordinary and necessary" apart from considerations of policy. United Draperies, Inc. v. Commissioner, 340 F.2d 936, 938 (7th Cir. 1965).

[2] Rev. Rul. 64-224, 1964-2 CUM. BULL. 52. The Ruling was issued in the wake of the famous "Philadelphia electric cases" in which many of the nations manufacturers of heavy electrical equipment were found guilty of rigging prices submitted to both public and private utility companies. Under the criminal provisions of the Sherman Act the manufacturing corporations were heavily fined; some 30 corporate executives received fines, and in a few cases, prison sentences. 1800 civil suits were then brought under the Clayton Act, and it has been estimated that at least $300,000,000 has been paid out by the electric companies in settlement of them. See STAFF OF JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, 89TH CONG., 2D SESS., STAFF STUDY OF INCOME TAX TREATMENT OF TREBLE DAMAGE PAYMENTS UNDER THE ANTITRUST LAWS 1-3 (Comm. Print 1965).

[3] 383 U.S. 687 (1966).

Tellier the issue was whether expenses for counsel incurred in a losing fight against a criminal charge growing out of the conduct of a business could be deducted as a business expense. The opinion states that an expense may be disallowed when allowance would frustrate a sharply defined policy of some other state or federal law. Further, the policy that might be frustrated must be one that is evidenced in a governmental declaration. Finally, the frustration which would result from allowance of the deduction must be severe to justify disallowance. In *Tellier* the deduction was allowed because there is no policy against the employment of counsel that could be frustrated by a deduction. The question this note attempts to answer is whether a deduction for treble damages paid by manufacturers convicted of price fixing should be disallowed under the three part test of *Tellier*.

Does Allowance Frustrate Sharply Defined Policy of The Clayton Act?

If the treble damages provided by section 4 of the Clayton Act are punitive, i.e., if the policy of section 4 is to deter price fixing, a strong argument can be made that deduction of those damages should not be allowed. The Commissioner continued to maintain that amounts paid for fines and penalties should not be deducted as a business expense,[4] because to do so would reduce the "sting" of the penalty and thereby encourage the taxpayer to violate the statute under which the penalty was imposed.[5] If, however, the purpose of the treble damages of the Clayton Act is to compensate the party injured in his business, the deduction should be allowed, just as compensatory damages paid by a business after judgment in a negli-

[4] Coed Records, Inc., 47 T.C. No. 41 (1967).

[5] Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30, 36 (1958). It has been pointed out that disallowance of a deduction does more than merely protect the policy of the statute that has been violated. When no deduction is given, the burden of the penalty is increased because the taxpayer must pay tax on money that he does not have. Since the economic impact of disallowance can vary greatly on different facts, and since this increase in tax burden may or may not show any relationship to the penalty provided by the statute that has been violated, critics have suggested that the doctrine of disallowance should be abandoned unless the statute that provides the penalty should itself call for disallowance of a deduction. Comment, *Business Expenses, Disallowance, and Public Policy: Some Problems of Sanctioning with the Internal Revenue Code*, 72 YALE L.J. 116-23 (1962); Keesling, *Illegal Transactions and the Income Tax*, 5 U.C.L.A. L. REV. 26, 34-40 (1958).

gence suit are deducted.[6] It is also possible that the treble damages of section 4 may serve both punitive and compensatory policies. In this case it would seem that the deduction should be disallowed to prevent frustration of one of the policies of the Clayton Act.[7]

In Revenue Ruling 64-224 the Commissioner takes the position that the treble damages of section 4 of the Clayton Act are compensatory in nature.[8] The legislative history of both the Sherman Act and the Clayton Act supports his position. Sections 1, 2, and 3 of the Sherman Act provide a fine of $50,000 and imprisonment for one year for violation of its provisions,[9] and it is clear that this fine may not be deducted as a business expense.[10] In contradistinction section 4 of the Clayton Act refers to "threefold damages" for "any person who shall be injured in his business or property."[11] Section 4A of the Clayton Act provides "actual damages" whenever the United States is injured by a violation of the antitrust laws.[12] During the debate Senator Sherman compared the two types of provisions:[13]

> It is the second section that gives the civil suit, and that is not to be prosecuted at all by the United States. . . . The first section deals with the public injury to the people of the United States and there the suit is brought . . . to restrain, limit, and control such arrangements as far as they are illegal. The second section gives a private remedy to every person injured. It seems to me the two sections are as distinct from each other as possible.

When asked more specifically if the treble damages of the proposed legislation were penal in nature, Senator Regan said, "This measure is given a civil remedy. It is not in the nature of a prosecution for crime."[14]

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[6] Helvering v. Hampton, 79 F.2d 358 (1935).

[7] In Cox v. Lykes, 237 N.Y. 376, 143 N.E. 226 (1924) (Cardoza, J.), it was said, "We are to remember that the same provision may be penal as to the offender and remedial as to the sufferer. . . . The nature of the problem will determine whether we are to take one viewpoint of the other."

[8] Rev. Rul. 64-224, 1964-2 CUM. BULL. 52.

[9] 69 Stat. 282 (1955), 15 U.S.C. §§ 1-3 (1964).

[10] See Anthony Cornero Stralla, 9 T.C. 801 (1949) (fines against illegal gambling business); Universal Atlas Cement Co. v. Commissioner, 9 T.C. 971 (1947), *aff'd*, 171 F.2d 294 (2d Cir. 1948), *cert. denied*, 336 U.S. 962 (1949) (state antitrust fines); I. T. 1174, I-1 CUM. BULL. 269 (1922).

[11] 38 Stat. 731 (1914), 15 U.S.C. § 15 (1964).

[12] 69 Stat. 212 (1955), 15 U.S.C. § 15a (1964).

[13] 21 CONG. REC. 2563 (1890).

[14] 21 CONG. REC. 3147 (1890). The provision under discussion became

The case law also provides considerable support for the Commissioner's position that the treble damages are compensatory. In *United States v. Cooper Corp.*[15] it was said that "the [Clayton] Act envisaged two classes of action—those made available to the government . . . and, in addition, a right of action for treble damages granted to redress private injury."[16] Cases involving other statutory damages analogous to the treble damages of the Clayton Act frequently stress the compensatory aspect of those damages. In *Overnight Transport Corp. v. Missel*[17] it was held that statutory double damages paid by an employer to an employee for failure to pay required overtime were compensatory. The theory of *Missel* is that the excess over actual damages provided by the statute is supplied not to punish, but to insure that the injured party will not be prevented from attaining an adequate recovery by the cost of a lengthy and complicated suit or difficulty in proving his damages.[18] Section 4 of the Clayton Act may reflect a similar policy in that it provides not only for enhanced damages but for the costs of suit and a reasonable attorney's fee as well.[19] Finally the Commissioner can also point to an older Ruling in which treble damages for payments to private parties under the Emergency Price Control Act of 1942 were held deductable.[20]

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section 7 of the Sherman Act, 26 Stat. 210 (1890). It was taken over, with minor changes, to become section 4 of the Clayton Act in 1914. When the fine under the Sherman Act was increased in 1955 from $5000 to $50,000, committee reports were issued indicating that the only penalties provided by antitrust law were those in the Sherman Act. H.R. REP. No. 618, 84th Cong., 1st Sess. 2 (1955); S. REP. No. 70, 84th Cong., 1st Sess. 3 (1955).

[15] 312 U.S. 600 (1941).

[16] *Id.* at 608

[17] 316 U.S. 572 (1942).

[18] *Id.* at 583. The Commissioner also points to Huntington v. Attrill, 146 U.S. 657, 686 (1892), holding that statutory damages are not penal in nature for purposes of enforcement of a judgment in a foreign jurisdiction, and to Brady v. Daly, 175 U.S. 148, 153 (1899), holding statutory damages not penal for application of a statute of limitations. The force of such cases is greatly reduced by the more recent case of Testa v. Katt, 330 U.S. 386 (1947) where it was held that even if the damages provided by a federal statute were considered penal, state courts would have to take jurisdiction over an action brought before them. Where a federal statute is involved, it is no longer necessary to label the damages "compensatory" in order to get a trial in a state court.

[19] 38 Stat. 731 (1914), 15 U.S.C. § 15 (1964).

[20] I. T. 3630, 1943 CUM. BULL. 113. Chiefly because of the precedent of I. T. 3630, the Antitrust Division of the Department of Justice has accepted the viewpoint of the Internal Revenue Service. This acceptance is important because another clue to the policy expressed by statutory damages may be found in the opinion of the administrative agency in charge of enforce-

Cases dealing specifically with Clayton Act recoveries contradict the Commissioner, however, in treating the two-thirds of an award that is in excess of actual damages as punitive in character. In *Commissioner v. Glenshaw Glass Corp.*,[21] where the taxpayer was an injured party who had received a treble damage award, the one-third actual damage was taxable to the recipient because it was compensation for lost income. It was held that the two-thirds excess damages were also taxable to the recipient, even though these damages were punitive. It would seem that whether the actual damages are taxable to the recipient as a replacement of lost income or are considered a tax free return of capital, they are compensatory from the point of view of the party paying the damages. In either event, however, the two-thirds excess would be characterized as penal. Lower court opinions express a theory that these punitive excess damages were made available to multiply the agencies that would help support the act,[22] increase public respect for the Sherman Act,[23] and provide a "sanction allowed to a private litigant, because of the public interest."[24]

The Commissioner's case is further weakened by a surprising inconsistency within Revenue Ruling 64-224 itself. A second holding of the Ruling is that *actual* damages paid to the government as an injured party under section 4A of the Clayton Act *may not* be deducted by the taxpayer as a business expense:

> Amounts paid in satisfaction of damage claims by the United States under section 4A of the Clayton Act . . . although resembling restitution, are in effect punishment for injury to the public occasioned by the violation of law. . . . The illegality

ment of the act providing the damages. See Jerry Rossman Corp. v. Commissioner, 175 F.2d 711, 713 (2d Cir. 1949). Although the Antitrust Division has expressed willingness to argue that Clayton Act damages are a penalty, it feels that allowance of the deduction will not necessarily encourage potential violators of the Sherman Act to treat the possibility of incurring treble damages as a "business risk." Even if full deduction is allowed, the business suffering judgment will still, if the income tax rate is 50%, be subjected to an irreplaceable loss of 150% on every dollar that is earned in violation of the Sherman Act. STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, STAFF STUDY OF INCOME TAX TREATMENT OF TREBLE DAMAGE PAYMENTS UNDER THE ANTITRUST LAWS, Appendix E (Comm. Print Nov. 1, 1965).

[21] 348 U.S. 426 (1955).

[22] Kinnear-Weed Corp. v. Humble Oil & Refining Co., 214 F.2d 891, 893 (5th Cir. 1954) (dictum).

[23] Maltz v. Sax, 134 F.2d 24 (7th Cir. 1943).

[24] Karseal Co. v. Richfield Oil Co., 221 F.2d 358, 365 (1955) (dictum).

> giving rise to the damage combined with the fact that the injury is inflicted upon the Government requires that such payments not be allowed as deductions.

The language of section 4A and section 4 is practically identical. It is a strange result that "actual damages" when paid to the government are punitive and "threefold damages" paid to private litigants are entirely compensatory. In both situations illegality gives rise to damages. If the recoupment of actual damages by the government is "in effect punishment for injury to the public," it does not seem unreasonable to assume that excess damages awarded to private litigants may contain an element of punishment. When the government is injured by an antitrust violation it has the purely punitive provisions of the antitrust statutes at its disposal. If the compensation for actual damages is also punishment, this fact tends to blur the distinction that might otherwise be made between the purely punitive provisions of antitrust laws and the multiple damages of the Clayton Act. Even if the distinction made by the Commissioner is not completely arbitrary,[25] it certainly suggests that if a court were presented with the issue of whether the treble damages of the Clayton Act contain an element of punitive damages designed to protect the public, it might well find that they do.

Is There a Sufficient Governmental Declaration?

If there is a penal policy in the treble damages of section 4 of the Clayton Act, there is a sufficient governmental declaration of that policy in the antitrust statutes to satisfy the second requirement for disallowing a deduction in *Tellier*. It is only required that the policy be *evidenced* in some statute or regulation and not that it be explicitly announced or defined.[26] This requirement originated in *Lilly v. Commissioner*[27] where opticians were disallowed a deduction for kickbacks paid to ophthalmologists who were sending them business. The tax court reasoned that since these payments were considered unethical by the medical profession, to allow their deduction would frustrate a public policy against them. In reversing, the United States Supreme Court refused to allow the tax court to roam

[25] For a vigorous defense of the Commissioner, see Lamont, *Controversial Aspects of Ordinary and Necessary Business Expense*, 42 Taxes 829-832 (1964).

[26] 383 U.S. 687, 694 (1965).

[27] 343 U.S. 90 (1952).

the moral landscape in search of policy and imposed the requirement that before a policy should be invoked against a deduction, it should be grounded on some official declaration of public law that the acts involved were objectionable.[28] Since the antitrust statutes set out both the prohibited conduct and the remedies available, they should provide sufficient evidence of policy to satisfy the minimal requirement of governmental declaration in *Tellier*.

Does Allowance of the Deduction for Treble Damages Present a "Severe" Frustration of Antitrust Policy?

The third requirement in *Tellier* is that the degree of frustration that would result from a deduction be "severe."[29] If there is a penal policy in Clayton Act treble damages, one can argue that to allow a deduction would work a direct and severe frustration of antitrust law.[30] The severity test has been used by the United States Supreme Court, however, not primarily to measure the absolute effect of allowance of a deduction on the policy of the law that has been violated, but rather to balance this harmful effect of allowance against the harmful effect that disallowance will have on the business that has claimed the deduction.[31] This balancing process is necessary because the legislative history of section 162 shows that Congress has been less concerned with protecting the public from

[28] *Id.* at 97.

[29] 383 U.S. 687, 694.

[30] See Commissioner v. Longhorn Portland Cement Co., 148 F.2d 276 (5th Cir. 1945), *cert. denied*, 326 U.S. 728 (1945), *reversing* 3 T.C. 310 (1944); Atzingen-Whitehouse Dairy, Inc., 36 T.C. 173 (1961).

[31] In Tank Truck Rentals v. Commissioner, 356 U.S. 30, 35 (1958), the use of the severity test was explained,

> [T]he test of non-deductability always is the severity and immediacy of the frustration resulting from allowance of the deduction. The flexibility of such a standard is necessary if we are to accommodate both the congressional intent to tax only net income and the presumption against congressional intent to encourage violation of public policy.

It would appear that the destructive effect of disallowance has also been a factor in decisions against the Commissioner on grounds other than the severity test. In Lilly v. Commissioner, 343 U.S. 90 (1952), where the requirement of governmental declaration was first announced, the Commissioner attempted to impose a total tax of $49,500 on a net profit of $25,000 for one of the taxable years in question. One writer has called this "taxation of gross income with a vengeance." Paul, *The Use of Public Policy by the Commissioner in Disallowing Deductions*, 1954 So. Calif. Tax Inst. 715, 737-42.

misuse of the expense deduction than it has been interested in establishing a morally neutral concept of net income.[32]

The awkwardness of the severity test is dramatically illustrated by the conflicting results of two cases decided in 1958 on the same day by the United States Supreme Court. In *Tank Truck Rentals, Inc. v. Comm'r*[33] the issue was whether fines paid by a trucking firm for violations of weight statutes could be deducted. The Court held that they could not, saying that to allow deduction of a payment that was *itself illegal* would present the most severe form of frustration of other law and that allowance of a fine would present a slightly less severe frustration that could also not be tolerated.[34] But in *Commissioner v. Sullivan* payments of rent and wages in the operation of a bookmaking establishment were in issue.[35] Although a state statute *specifically prohibited* these payments,[36] the Court held that they could be deducted: "If we enforce as federal policy the rule espoused by the Commissioner in this case, we would come close to making this type of business taxable on the basis of its gross receipts, while all other business would be taxable on the basis

[32] The basic purpose of section 162 is to allow a determination of how much money a business has left over after expenses. In 1913 it was urged in debate on the first income tax bill that only lawful expenses be allowed as deductions and the answer, in the words of Senator Williams, could not have been clearer:

> [T]he object of this bill is to tax a man's net income; that is to say, what he has at the end of the year after deducting from his receipts his expenditures or losses. It is not to reform men's moral character; that is not the object of the bill at all. The tax is not levied for the purpose of restraining people from betting on horse races or upon "futures," but the tax is framed for the purpose of making a man pay upon his net income, his actual profit during the year. The law does not care where he got it from, so far as the tax is concerned, although the law may very properly care in another way.

50 CONG. REC. 3849 (1913). See also SEIDMAN, LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS, 1938-1961, 995-97 (1963). Congress has since repeatedly refused to include a provision in the Code that would generally disallow immoral or undesirable expenses. For a detailed review see Comment, *Business Expenses, Disallowance, and Public Policy: Some Problems of Sanctioning with the Internal Revenue Code*, 72 YALE L.J. 111-112 (1962).

[33] 356 U.S. 30 (1958).

[34] *Id.* at 35.

[35] 356 U.S. 27 (1958).

[36] Thus bringing the issue squarely within the language of the *Tank Truck Rentals*, which should result in disallowance. This is distinguishable from the situation where deduction of an otherwise legal expense incurred in the pursuit of an illegal business is allowed. *Compare* Commissioner v. Doyle, 231 F.2d 635, 637 (7th Cir. 1956) *with* Allen v. Commissioner, 283 F.2d 785, 790 (1960).

of net income. If that choice is to be made, Congress should do it." The court then said that only if it were "clear that the allowance is a device to avoid the consequences of violations of law" should the deduction be disallowed.[37]

How then would Clayton Act treble damages be treated under the severity test? On the one hand, allowance of the deduction certainly permits the taxpayer to "avoid the consequences" of an antitrust violation, and, if this dictum in *Sullivan* is followed, the deduction should be disallowed.[38] Where a Clayton Act suit is based on a prior criminal conviction under the Sherman Act,[39] there is an appealing argument that the relatively weak provisions of the Sherman Act should be buttressed through disallowance.[40] On the other hand, payment of treble damages can have a heavy impact on a firm. If this impact is so great as to destroy or seriously impair a firm's competitive position,[41] disallowance of the deduction would conflict

[37] 356 U.S. 27, 29 (1958).

[38] *Ibid.*

[39] Where there has been a criminal conviction, there is no doubt that the guilty parties knowingly entered into a conspiracy to restrain trade and it is under these circumstances that the deterrence of non-deductability would be most useful. In litigation over deductability of damages paid under the Emergency Price Control Act of 1942 a distinction between willful and innocent violations was made with the result that deduction was denied where the violation was willful but allowed where innocent. *Compare* National Brass Works, Inc. v. Commissioner, 16 T.C. 1051 (1951), *aff'd*, 205 F.2d 104 (9th Cir. 1953) *with* Jerry Rossman Corp. v. Commissioner, 175 F.2d 711 (2d Cir. 1949).

[40] The number of Clayton Act suits has increased greatly in recent years to the point where they may be considered a major means of enforcement of antitrust law. Bicks, *The Department of Justice and Private Treble Damage Actions*, 4 ANTITRUST BULL. 5 (1959). If private claimants must pay income tax on the two-thirds excess damages received, see note 21 *supra*, it would perhaps be desirable to offset this factor deterring claimants from exercising their enforcement function with a concomitant factor of non-deductability to deter potential violators. On the other hand, it might be more desirable in view of the basic policy of encouragement of competition to encourage claimants by excluding the two-thirds excess from gross income and allowing deductions by defendants. See generally Loevinger, *Private Action—The Strongest Pillar of Antitrust*, 3 ANTITRUST BULL. 167 (1958).

[41] The Attorney General has recognized the danger of excessive damages to the competitive positions of firms, especially small firms, in his own suits on behalf of the United States for actual damages under 4A of the Clayton Act. In recent suits following the "Philadelphia electric cases" the Attorney General settled for as much as 10% of total sales with major manufacturers and as little as 2% from small firms. STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, STAFF STUDY OF INCOME TAX TREATMENT OF TREBLE DAMAGE PAYMENTS UNDER THE ANTITRUST LAWS, 9-11 (Comm. Print Nov. 1, 1965).

with both the policy of the Internal Revenue Code to tax only net income and the policy of the Sherman Act to encourage competition.[42] If presented with a case where disallowance of the deduction would have a crippling effect on a firm, a court might be motivated, although it could not easily say so, to allow the deduction in order to protect the competitive position of the firm. In this event the court could allow the deduction, as in *Sullivan*, by stressing the intent of Congress to tax only net income. Such a holding would amount, however, to virtual abandonment of disallowance of deductions for fines and penalties on the grounds of public policy.

CONCLUSION

It is apparent that there is no clear answer to the question whether allowance of the deduction for treble damages frustrates policy of the Clayton Act because it is unclear whether that policy is penal or compensatory. There is, however, a sufficient governmental declaration to justify a decision either way, and if a court were to find a significant penal policy present in the Clayton Act, the first and second tests in *Tellier* for disallowing a deduction would be met. Furthermore, under the dictum in *Sullivan*, if a penal policy were found in the Clayton Act, the third test of severity would be met. In view of the ease, however, with which the United States Supreme Court abandoned the position it took in *Tank Truck Rentals* when it was faced, in *Sullivan*, with a business that would be destroyed by disallowance, it is possible that a deduction for Clayton Act treble damages might be allowed if necessary to preserve competition. One could argue that since the issues are so uncertain, the Commissioner was well within proper exercise of discretion to grant the deduction in a Revenue Ruling. The better view, however, is that the Commissioner was incorrect to decide a question of such great public interest in a way that forecloses litigation.[43]

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[42] The emphasis of modern antitrust law has shifted from the negative "trustbusting" theme of the early 1900's to a more positive theme of maintaining competition in all possible ways. Penalties which are so great as to damage ability to compete would be self-defeating. See generally NEALE, THE ANTITRUST LAWS OF THE UNITED STATES OF AMERICA 29-30 (1962).

[43] For the views of Senator Hart, Chairman of the Senate Antitrust and Monopoly Subcommittee, and Representative Celler, Chairman of the House Committee on the Judiciary and its Antitrust Subcommittee, see 42 TAXES 830 (1964). See generally United States v. Borden, 308 U.S. 188, 187 (1939).

Torts— Dog Owner's Statutory Liability in North Carolina

Homer Truitt, age five, was bitten by a dog in and about his left eye. The attack occurred within the city limits of High Point, Guilford County, North Carolina. Six months later, two claims for damages were filed with the Board of County Commissioners of Guilford County, one by the mother in behalf of Homer Truitt for the dog bite injury, and one by the father for medical expenses he had paid for the treatment of his son's injury.[1] The claims were filed pursuant to N.C. GEN. STAT. § 67-13 (1965),[2] the relevant portions of which are as follows:

> The money arising under the provisions of this article [license tax on dogs[3]] shall be applied to the school funds of the county in which said tax is collected: Provided, it shall be the duty of the county commissioners, upon complaint made to them of *injury to person* or injury to or destruction of property by any dog, upon satisfactory proof of such injury or destruction, to appoint three free-holders to ascertain the amount of damages done, including necessary treatment, if any, and all reasonable expences incurred, and upon the coming in of the report of such jury of the damage as aforesaid, the said county commissioners shall order the same paid out of any moneys arising from the tax on dogs as provided for in this article. . . .[4]

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[1] Record, p. 6, *In re* Truitt, 269 N.C. 249, 152 S.E.2d 74 (1967).

[2] The following amendments to N.C. GEN. STAT. § 67-13 (1965) are applicable to Guilford County: N.C. Sess. Laws 1933, ch. 547; N.C. Sess. Laws 1945, ch. 138; N.C. Sess. Laws 1951, ch. 143.

[3] "Any person owning or keeping about him any . . . dog shall pay annually a license or privilege tax. . . ." N.C. GEN. STAT. § 67-5 (1965). This statute levying the dog tax has been upheld as constitutional on two grounds. The first is that it is a privilege tax levied for a valid public purpose, that purpose being to get rid of worthless dogs likely to be a nuisance and to preserve only those valuable enough for their owners to pay the tax on them. See McAlister v. Yancey County, 212 N.C. 208, 193 S.E. 141 (1937); Newell v. Green, 169 N.C. 462, 86 S.E. 291 (1915); Mowery v. Town of Salisbury, 82 N.C. 175 (1880). The second is that it is a valid police regulation to control and to regulate dogs. See Board of Comm'rs v. George, 182 N.C. 414, 109 S.E. 77 (1921); Newell v. Green, 169 N.C. 462, 86 S.E. 291 (1915). *Accord,* City of Birmingham v. West, 236 Ala. 434, 183 So. 421 (1938); City of Dickinson v. Thress, 69 N.D. 748, 290 N.W. 653 (1940). See generally Annot., 49 A.L.R. 848 (1927).

[4] N.C. GEN. STAT. § 67-13 (1965). [Emphasis added.] The statute is similar to those of other states which impose a tax on dogs with the tax revenues being used to compensate owners of livestock for injuries to the livestock caused by dogs. CONN. GEN. STAT. REV. § 22-355 (1958); ILL. REV. STAT. ch. 8, § 15 (1966); IND. ANN. STAT. § 16-324 (1964); MASS. GEN. LAWS ANN. ch. 140, § 161 (1965); MINN. STAT. ANN. § 347.15

The Board of Commissioners of Guilford County denied these claims, but on appeal to the superior court, a judgment in favor of both claimants was entered. The county's appeal to the Supreme Court of North Carolina unsuccessfully attacked the constitutionality of the statute under which the claimants sued.[5] Unconstitutionality was asserted on the grounds that the statute: (1) authorizes the payment of private claims out of dog-tax revenues in violation of N.C. CONST. art. VII, § 6 (which prohibits counties from levying any tax for expenses other than necessary ones without a vote of a majority of the electorate);[6] and (2) contravenes N.C. CONST. art. I, § 7 (which prohibits the granting of "exclusive or separate emoluments or privileges").[7]

(1957); MO. ANN. STAT. § 273.110 (1959); NEB. REV. STAT. § 54-603 (1960); N.H. REV. STAT. ANN. § 466:21 (1955); N.J. REV. STAT. § 4:19-4 (1959); OHIO REV. CODE ANN. § 955.29 (1954); ORE. REV. STAT. § 609.170 (1953); PA. STAT. ANN. tit. 3, § 488 (1963); R.I. GEN. LAWS ANN. § 4-13-20 (1957); VA. CODE ANN. § 29-209 (1964); WASH. REV. CODE ANN. § 16.08.010 (1962); WIS. STAT. ANN. § 174.11 (1957). These statutes are generally upheld, not as taxes within the "public purpose" concept, but as valid police regulations. *E.g.*, Wisdom v. Board of Supervisors, 236 Iowa 669, 19 N.W.2d 602 (1945); Nichols v. Logan, 184 Ky. 711, 213 S.W. 181 (1919); Worcester County v. Ashworth, 160 Mass. 186, 35 N.E. 773 (1893); Van Horn v. People, 46 Mich. 183, 9 N.W. 246 (1881); Hofer v. Carson, 102 Ore. 545, 203 Pac. 323 (1922); State v. Anderson, 144 Tenn. 564, 234 S.W. 768 (1921).

> The taxing act having been held valid and its main objective being to create a fund to pay damage caused by dogs, is not the purpose valid? . . . Since the levy for the stated purpose has been declared valid and not in contravention of the State Constitution, it seems clear the validity extends to the expenditure of funds for the stated purpose.

Id. at 252, 152 S.E.2d at 76.

[6] The decisions heretofore rendered by the Court make the test of a 'necessary expense' the purpose for which the expense is to be incurred. If the purpose is the maintenance of the public peace or the administration of justice; if it partakes of a governmental nature or purports to be an exercise by the city of a portion of the State's delegated sovereignty; if, in brief, it involves a necessary governmental expense—in these cases the expense required to effect the purpose is 'necessary' within the meaning of Art. VII, sec. 7 [now sec. 6], and the power to incur such expense is not dependent on the will of the qualified voters.

Henderson v. City of Wilmington, 191 N.C. 269, 279, 132 S.E. 25, 30 (1926). The county in the principal case contended that the statute authorizing the payment of claims combined with the levy of the dog tax constituted a levy of a tax to finance a non-necessary expense, that is, compensation of private claims. Brief for Appellant, pp. 4-8. See also Brief for Appellees, pp. 2-6.

[7] The Constitutional limitation contained in Art. I, sec. 7, has been frequently invoked by this Court to strike down legislation conferring special privileges not in consideration of public service. . . . But

Under the statute[8] involved in *In re Truitt*,[9] a party injured by a dog has a cause of action against the county for his damages; the county, upon payment of these damages, then has a cause of action against the dog's owner for reimbursement. This statute[10] presents two distinct problems. The first, the constitutional question,[11] has been considered and answered many times by the North Carolina Supreme Court,[12] as it was in the principal case.[13] The second is unrelated to the first and has never been answered by the court. Undecided as yet is the question of what relationship, if any, this statute bears to the common law liability of dog owners for injuries inflicted by their dogs. This note will primarily be directed to this question.[14]

In North Carolina, *scienter* is the basis of a dog owner's common law liability for injuries inflicted by his dog.[15] Liability arises

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where the motivation is for a public purpose and in the public interest, and does not confer exclusive privilege, legislation has been upheld. Brumley v. Baxter, 225 N.C. 691, 698, 36 S.E.2d 281, 286 (1945). See Brief for Appellant, pp. 8-10; Brief for Appellees, pp. 7-8.

[8] N.C. GEN. STAT. § 67-13 (1965).

[9] 269 N.C. 249, 152 S.E.2d 74 (1967).

[10] N.C. GEN. STAT. § 67-13 (1965).

[11] Though legislative determination of what constitutes a public purpose and a necessary expense is given great weight by the Court, the final determination is for the Court. Horton v. Redevelopment Comm'n, 259 N.C. 605, 131 S.E.2d 464 (1963); Dennis v. City of Raleigh, 253 N.C. 400, 116 S.E.2d 923 (1960); Nash v. Town of Tarboro, 227 N.C. 283, 42 S.E.2d 209 (1947); Purser v. Ledbetter, 227 N.C. 1, 40 S.E.2d 702 (1946); Palmer v. Haywood County, 212 N.C. 284, 193 S.E. 668 (1937); Starmount Co. v. Hamilton Lakes, 205 N.C. 514, 171 S.E. 909 (1933).

[12] The constitutional determination has been more by implication than by direct holding on the precise issue of whether the expense is a necessary one. White v. Commissioners, 217 N.C. 329, 7 S.E.2d 825 (1940); McAlister v. Yancey County, 212 N.C. 208, 193 S.E. 141 (1937); Board of Comm'rs v. George, 182 N.C. 414, 109 S.E. 77 (1921); Newell v. Green, 169 N.C. 462, 86 S.E. 291 (1915).

[13] The answer given by the court to the constitutional challenge was that the expenditure of county funds to pay these claims was for a valid public purpose. *In re* Truitt, 269 N.C. 249, 152 S.E.2d 74 (1967).

[14] An analysis of the basis of the dog owner's responsibility under the statute is based on the assumption that the dog owner can be found and is capable of reimbursing the county for the amount of damages paid out by it. The statute, however, does call for the county's payment of claims even where no possibility of reimbursement is present, that is, where the owner is unknown. N.C. GEN. STAT. § 67-13 (1965).

[15] See Sink v. Moore, 267 N.C. 344, 148 S.E.2d 265 (1966); Pegg v. Gray, 240 N.C. 548, 82 S.E.2d 757 (1954); Hobson v. Holt, 233 N.C. 81, 62 S.E.2d 524 (1950); Plumides v. Smith, 222 N.C. 326, 22 S.E.2d 713 (1942); Hill v. Moseley, 220 N.C. 485, 17 S.E.2d 676 (1941); Rector v. Southern Coal Co, 192 N.C. 804, 136 S.E. 113 (1926); State v. Smith, 156 N.C. 628, 72 S.E. 321 (1911).

only if two essential factors are present:[16] the animal that inflicts the injury possesses a "vicious propensity,"[17] and the owner has actual or constructive knowledge of such propensity.[18] When these two prerequisites are established, the owner's liability is predicated on his negligent failure to confine or restrain the dog.[19] But in many jurisdictions negligence need not be shown, and the owner's liability is based upon *scienter* alone,[20] on the theory that he is harboring a

[16] Pegg v. Gray, 240 N.C. 548, 82 S.E.2d 757 (1954); Plumides v. Smith, 222 N.C. 326, 22 S.E.2d 713 (1942); Rector v. Southern Coal Co., 192 N.C. 804, 136 S.E. 113 (1926); 66 A.L.R.2d 916, 921-22 (1959). The complaint of an injured party is fatally defective without allegation of both of these factors. Sellers v. Morris, 233 N.C. 560, 64 S.E.2d 662 (1951).

[17] The term "vicious propensity" ". . . does not connote a mere playful canine trickster. It connotes conduct 'producing or tending to produce mischief or harm; injurious; deleterious; hurtful.' . . . On the other hand, if the habit of the dog is one which is likely to cause injury, it is immaterial that the dog was playing."

Sink v. Moore, 267 N.C. 344, 350, 148 S.E.2d 265, 269-70 (1966). *Accord*, Hill v. Moseley, 220 N.C. 485, 17 S.E.2d 676 (1942).

[18] The dog is no longer entitled to one bite before the owner can be charged with knowledge of the vicious propensity. "Under the modern view trial courts undertake to judge [the owner's knowledge] of the vicious propensities of animals by their behavior, although it may fall short of actual injury." Hill v. Moseley, 220 N.C. 485, 489, 17 S.E.2d 676, 678 (1942). See RESTATEMENT, TORTS § 509, comment *g* (1938). Evidence of the dog's reputation is generally admissible to establish knowledge on the part of the dog owner of the vicious propensity, though it is inadmissible as proof of the dog's vicious propensity. Hill v. Moseley, 220 N.C. 485, 17 S.E.2d 676 (1942).

[19] The test of liability under such an interpretation is ". . . whether the owner should know from the dog's past conduct that he is likely, if not restrained, to do an act from which a reasonable person, in the position of the owner, could foresee that an injury to the person or property of another would be likely to result."

Sink v. Moore, 267 N.C. 344, 350, 148 S.E.2d 265, 270 (1966); State v. Smith, 156 N.C. 628, 72 S.E. 321 (1911). *Accord*, Williams v. Moray, 74 Ind. 25, 39 Am. Rep. 76 (1881); Brune v. DeBenedetty, 261 S.W. 930 (Mo. Ct. App. 1924); Moore v. McKay, 55 S.W.2d 865 (Tex. Ct. App. 1933). Other than the negligence theory, two other interpretations of the scienter action have been advanced. (1) The owner is harboring a nuisance by keeping a vicious dog. Turner v. Shropshire, 285 Ky. 256, 147 S.W.2d 388 (1941); Tidal Oil Co. v. Forcum, 189 Okla. 268, 116 P.2d 572 (1941). (2) The owner is strictly liable for keeping a vicious dog. Zarek v. Fredericks, 138 F.2d 689 (3d Cir. 1943); Brewer v. Furtwangler, 171 Wash. 617, 18 P.2d 837 (1933); RESTATEMENT, TORTS § 509 (1938); Annot., 66 A.L.R.2d 916, 922 (1959). North Carolina rejects the view that the owner's knowledge of the vicious propensity creates strict liability, in favor of coupling a higher standard of care, based on the owner's higher knowledge, with the general rule that one having charge of an animal must exercise ordinary care in keeping it restrained. Herndon v. Allen, 253 N.C. 271, 116 S.E.2d 728 (1960).

[20] See notes 21 and 22 *infra*.

nuisance[21] or that he is strictly liable.[22]

The requirements for imposing liability on a dog owner in a particular jurisdiction determine what defenses are available to the dog owner.[23] Thus, in jurisdictions such as North Carolina where the *scienter* action depends on the owner's negligence in failing to restrain the dog, the injured party's contributory negligence precludes his recovery.[24] However, in jurisdictions that impose liability for keeping a vicious dog without proof of negligence in the manner of keeping it,[25] contributory negligence is not available as a defense to the dog owner.[26] Yet courts of these jurisdictions are reluctant to deprive the dog owner of all defenses, and they traditionally bar recovery if plaintiff's conduct amounts to voluntary assumption of the risk[27] or intentional provocation of the dog's attack.[28]

An examination of the statute[29] involved in *In re Truitt*[30] may be helpful before an attempt is made to ascertain what relationship,

[21] Turner v. Shropshire, 285 Ky. 256, 147 S.W.2d 388 (1941); Tidal Oil Co. v. Forcum, 189 Okla. 268, 116 P.2d 572 (1941).

[22] Zarek v. Fredericks, 138 F.2d 689 (3d Cir. 1943); Brewer v. Furtwangler, 171 Wash. 617, 18 P.2d 837 (1933).

[23] See Annot., 66 A.L.R.2d 916 (1959).

[24] A bare majority of jurisdictions take this position. *E.g.*, Frederickson v. Kepner, 82 Cal. App. 2d 905, 187 P.2d 800 (Dist. Ct. App. 1947); Swerdfeger v. Krueger, 145 Colo. 180, 358 P.2d 479 (1960); Ryan v. Marren, 216 Mass. 556, 104 N.E. 353 (1914). Though in Hill v. Moseley, 220 N.C. 485, 17 S.E.2d 676 (1942), the court expressed some doubt as to whether knowledge of a dog's vicious propensity creates strict liability, the strict liability theory was rejected and contributory negligence was accepted as a defense by Hobson v. Holt, 233 N.C. 81, 62 S.E.2d 524 (1950).

[25] See note 24 *supra.*

[26] Burke v. Fischer, 298 Ky. 157, 182 S.W.2d 638 (1944); Tidal Oil Co. v. Forcum, 189 Okla. 268, 116 P.2d 572 (1941); Brewer v. Furtwangler, 171 Wash. 617, 18 P.2d 837 (1933).

[27] Burke v. Fischer, 298 Ky. 157, 182 S.W.2d 638 (1944); Corley v. Hubbard, 129 Neb. 38, 260 N.W. 551 (1935); Silber v. Seidler, 19 Misc. 2d 516, 188 N.Y.S.2d 111 (Sup. Ct. 1959); Brown v. Barber, 26 Tenn. App. 534, 174 S.W.2d 298 (1943); RESTATEMENT, TORTS § 515 (1938). The availability of the assumption of risk defense to the dog owner is limited by the rule that a plaintiff does not assume the risk of defendant's negligence. Brune v. DeBenedetty, 261 S.W. 930 (Mo. Ct. App. 1924).

[28] Such a defense is applicable where plaintiff knows of the vicious propensity of a dog and wantonly excites it or unnecessarily puts himself in the way of the animal so that he brings the injury on himself. Muller v. McKesson, 73 N.Y. 195, 29 Am. Rep. 123 (1878). *Accord,* Klatz v. Pfeffer, 333 Ill. 90, 164 N.E. 224 (1928); Tidal Oil Co. v. Forcum, 189 Okla. 268, 116 P.2d 572 (1941); Brown v. Barber, 26 Tenn. App. 534, 174 S.W.2d 298 (1943); Moore v. McKay, 55 S.W.2d 865 (Tex. Ct. App. 1933).

[29] N.C. GEN. STAT. § 67-13 (1965).

[30] 269 N.C. 249, 152 S.E.2d 74 (1967).

if any, it has to the foregoing common law principles. The statute[31] provides that upon complaint made to the county commissioners of personal injury[32] by any dog and upon satisfactory proof of the injury, the injured party is entitled to recover damages from the county commissioners for injuries sustained. The county commissioners are then entitled to sue the owner of the dog, if he can be found, and upon proof of payment of the injured party's claim by the county, the owner must reimburse the county.[33] Aside from the circuitous method by which the dog owner's liability is determined, the statute on its face differs from the common law in three respects. First, the *scienter* requirement is not mentioned by the statute; apparently, it is unnecessary for the county to prove the owner knew or had reason to know of the dog's vicious propensity in order to hold the owner liable. Second, there is nothing in the statute indicating that an inquiry into the nature of the conduct of the injured party would be relevant, either by the county commissioners or by the dog's owner; in other words, the statute on its face preserves no common law defenses. Third, it is possible that the injured party is given by this statute an absolute right to recover his damages, and the dog's owner is placed under an absolute obligation to reimburse the county. The obvious question posed is whether or not these differences signify a legislative intent to abrogate, by statute, the common law principles of liability and to create an entirely new basis of liability and recovery.

A possible interpretation of the statute[34] is that it indicates a legislative intent to ease the burden of proof of the injured party and to provide him with a ready and speedy recovery, rather than an intent to change the negligence basis of liability. This interpretation is achieved by emphasizing the absence of a *scienter* requirement in the statute and the fact that the recovery is available from the county. By suing under the statute, an injured party is relieved of both the delay and expense involved in a suit under the common law. As soon as he is able to prove a valid claim, he can recover his damages from the county, thus leaving the burden on the county to find the dog's owner and to make him pay. The position that the

[31] N.C. GEN. STAT. § 67-13 (1965).

[32] The statute also applies to "injury to or destruction of property by any dog. . . ." N.C. GEN. STAT. § 67-13 (1965).

[33] N.C. GEN. STAT. § 67-13 (1965).

[34] N.C. GEN. STAT. § 67-13 (1965).

absence of a *scienter* requirement manifests legislative intent to ease the claimant's burden of proof is consistent with the wide-spread legislative erosion of unduly restrictive common law recovery theories.[35] Many states have enacted so-called "dog bite" statutes that eliminate the necessity of the injured party's proving *scienter* on the part of the dog's owner.[36] The purpose of abolishing the *scienter* requirement in these statutes was not to heighten the responsibility of the dog owner, that is, to change the *basis* of common law liability, but merely to abolish the common law *scienter* requirement that frequently imposed on the claimant a burden of proof unduly restricting recovery.[37]

Aside from the fact these statutes ease the burden of proof by abolishing the *scienter* requirement, some of them, like the North Carolina statute, do not expressly provide for retention of any of the common law defenses;[38] others limit the defenses available to intentional provocation of the dog by the injured party,[39] or the injured party's tortious conduct,[40]or both.[41] Yet even in suits under

[35] See notes 36 and 37 *infra*. See generally 1960 DUKE L.J. 146 (1960).

[36] ALA. CODE tit. 3, § 102 (1960); ARIZ. REV. STAT. ANN. § 24-521 (1956); CAL. CIV. CODE § 3342; CONN. GEN. STAT. REV. § 22.357 (1958); FLA. STAT. ANN. § 767.04 (1964); ILL. REV. STAT. ch. 8, § 12d (1966); IND. ANN. STAT. § 16-214 (1964); IOWA CODE ANN. § 351-28 (1949); MASS. GEN. LAWS ANN. ch. 140, § 155 (1965); MICH. STAT. ANN. § 12.544 (1958); MINN. STAT. ANN. § 347.22 (1957); MONT. REV. CODES ANN. § 17-409 (1955); NEB. REV. STAT. § 54-601 (1960); N.H. REV. STAT. ANN. § 466:19 (1955); N.J. REV. STAT. ANN. § 4:19-16 (1959); OHIO REV. CODE ANN. § 955.28 (1954); OKLA. STAT. ANN. tit. 4, § 42.1 (1964); R.I. GEN. LAWS ANN. § 4-13-16 (1956); TENN. CODE ANN. § 44-101 (1964); UTAH CODE ANN. § 18-1-1 (1953); WASH. REV. CODE ANN. § 16.08.040 (1962); W. VA. CODE ANN. § 19-20-13 (1966); WIS. STAT. ANN. § 174.02 (1957). Alabama, however, allows the owner to plead in mitigation of damages his lack of scienter of the vicious propensity of the dog. ALA. CODE tit. 3, § 103 (1960).

[37] Ellsworth v. Elite Dry Cleaners, 127 Cal. App. 2d 479, 274 P.2d 17 (Dist. Ct. App. 1954); Vandecar v. David, 96 So. 2d 227 (Fla. Dist. Ct. App. 1957); Wojewoda v. Rybarczyk, 246 Mich. 641, 225 N.W. 555 (1929); Foy v. Dayko, 82 N.J. Super. 8, 196 A.2d 535 (1964); Nelson v. Hansen, 10 Wis. 2d 107, 102 N.W.2d 251 (1960).

[38] CAL. CIV. CODE § 3342; NEB. REV. STAT. § 54-601 (1960); R.I. GEN. LAWS ANN. § 4-13-16 (1956); TENN. CODE ANN. § 44-101 (1964); UTAH CODE ANN. § 18-1-1 (1953); W. VA. CODE ANN. § 19-20-13 (1966); WIS. STAT. ANN. § 174.02 (1957).

[39] ALA. CODE tit. 3, § 102 (1960); ARIZ. REV. STAT. ANN. § 24-523 (1956); FLA. STAT. ANN. § 767.04 (1964); ILL. REV. STAT. ch. 8, § 12d (1966); IND. ANN. STAT. § 16-214 (1964); MICH. STAT. ANN. § 12.544 (1958); MINN. STAT. ANN. § 347.22 (1957); MONT. REV. CODES ANN. § 17-409 (1955).

[40] IOWA CODE ANN. § 351.28 (1949); N.H. REV. STAT. ANN. § 466:20 (1955); N.J. REV. STAT. ANN. § 4:19-16 (1959).

[41] CONN. GEN. STAT. REV. § 22-357 (1958); MASS. GEN. LAWS ANN. ch.

these statutes with limited or no defenses, courts indicate a decided reluctance to hold the dog's owner liable when the injured party is guilty of intentional fault.[42] The common law inquiry into the nature of the injured party's conduct remains intact, at least to the extent of assumption of the risk and intentional provocation of the dog.[43]

Thus the differences between the common law and the North Carolina statute do not necessarily warrant the interpretation that a new basis of liability is created by the statute. Assuming that the statute does not change the North Carolina negligence theory of recovery, the significance of the differences between the common law

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140, § 155 (1965); OHIO REV. CODE ANN. § 955.28 (1954); OKLA. STAT. ANN. tit. 4, § 42.1 (1964).

[42] Under a statute which did not expressly provide for retention of any common law defenses, the California Court stated:

> We entertain no doubt that in adopting the Statute here in question the Legislature did not intend to make the liability of the owner absolute and render inoperative certain principles of law such as assumption of risk or wilfully inviting injury. . . . While the Dog Bite Statute does not found the liability on negligence, good morals and sound reasoning dictate that if a person lawfully upon the portion of another's property where the biting occurred should kick, tease, or otherwise provoke the dog, the law should and would recognize the defense that the injured person by his conduct invited injury and therefore, assumed the risk thereof. . . .

Smythe v. Schacht, 93 Cal. App. 2d 315, 209 P.2d 114, 118 (Dist. Ct. App. 1949). *Accord,* Ellsworth v. Elite Dry Cleaners, 127 Cal. App. 2d 479, 274 P.2d 17 (Dist. Ct. App. 1954); Kowal v. Archibald, 148 Conn. 125, 167 A.2d 859 (1961); Josephson v. Sweet, 173 So. 2d 463 (Fla. Dist. Ct. App. 1964); Vandecar v. David, 96 So. 2d 227 (Fla. Dist. Ct. App. 1957); Koller v. Duggan, 346 Mass. 270, 191 N.E.2d 475 (1963); Wojewoda v. Rybarczyk, 246 Mich. 641, 225 N.W. 555 (1929); Lavalle v. Kaupp, 240 Minn. 360, 61 N.W.2d 228 (1953); Gagnon v. Frank, 83 N.H. 122, 139 Atl. 373 (1927); Colby v. Lee, 83 N.H. 303, 142 Atl. 115 (1928); Foy v. Dayko, 82 N.J. Super. 8, 196 A.2d 535 (1964); Peck v. Williams, 24 R.I. 583, 54 Atl. 381 (1903); Nelson v. Hansen, 10 Wis. 2d 107, 102 N.W.2d 251 (1960); Schraeder v. Koopman, 190 Wis. 459, 209 N.W. 714 (1926); Legault v. Malacker, 166 Wis. 58, 163 N.W. 476 (1917).

Some jurisdictions, however, require that the fault of the injured party must amount to assumption of risk or intentional provocation of the dog, and not just contributory negligence, before his conduct will bar his recovery. Doerfler v. Redding, 2 Conn. Cir. 694, 205 A.2d 502 (Cir. Ct. App. (1964); Duell v. Coyle, 22 Conn. Supp. 332, 171 A.2d 427 (Super. Ct. 1961); Knapp v. Ball, 175 So. 2d 808 (Fla. Dist. Ct. App. 1965); Miles v. Schrunk, 139 Iowa 563, 117 N.W. 971 (1908); Siegfried v. Everhart, 55 Ohio App. 351, 9 N.E.2d 891 (1936); McCarthy v. Daunis, 167 Atl. 918 (Conn. Sup. Ct. Err. 1933).

[43] Quaere whether there is any significance in the fact that in the principal case counsel for the county was allowed without objection to question the brother of the injured party with respect to the conduct of the children around the dog immediately before the injury took place. See Record, p. 26.

and the statute can be interpreted as follows: the lack of the *scienter* requirement in the statute means that the injured party has an easier burden of proof;[44] the lack of any express retention of common law defenses means that all defenses[45] not expressly abolished by the statute are retained;[46] and the fact the injured party can sue the county means he can recover his damages quickly. The county's obligation to pay the injured party's claim and to sue the owner of the dog would then seem to be based on subrogation principles; only where the injured party has a valid claim and the owner has no valid defense would the county pay the claim and seek reimbursement.[47]

On the other hand, by concentrating solely on the language in which the dog owner's liability is phrased in the statute, the conclusion may also be drawn that the legislature *did* intend to change the underlying basis of the dog owner's responsibility to that of strict liability. The statute plainly provides that the injured party who can prove his damages *shall be compensated* for that amount;[48] similarly, the owner of the dog ". . . *shall reimburse* the county to the amount paid out [by the county to the injured party] for such injury. . . ."[49] Nowhere in the statute is there express recognition that any of the common law defenses would be applicable in a suit under the statute. Such absolute phraseology is characteristic of

[44] See notes 36 and 37 *supra* and accompanying text.

[45] That is, contributory negligence, assumption of risk, and intentional provocation of the dog.

[46] See note 42 *supra*, and especially Nelson v. Hansen, 10 Wis. 2d 107, 102 N.W.2d 251 (1961). So much of the common law as has not been abrogated or repealed by statute is in full force and effect in North Carolina. N.C. GEN. STAT. § 4-1 (1953).

[47] "Legal subrogation . . . is a device adopted by equity to compel the ultimate discharge of an obligation by him who in good conscience ought to pay it. It arises when one person has been compelled to pay a debt which ought to have been paid by another and for which the other was primarily liable." Beam v. Wright, 224 N.C. 677, 683, 32 S.E.2d 213, 218 (1944). The chance that an injured party could be compensated by the county for a claim to which the dog owner has a valid defense (which would only be raised later, in the county's suit against the dog owner) could be eliminated by joining the dog owner in the proceeding by the injured party against the county.

[48] Upon proof of the amount of damages done, "the said county commissioners shall order the same paid out of any moneys arising from the tax on dogs. . . ." N.C. GEN. STAT. § 67-13 (1965). Mandamus lies to compel the county to consider an injured party's claim. White v. Commissioners, 217 N.C. 329, 7 S.E.2d 825 (1940).

[49] N.C. GEN. STAT. § 67-13 (1965). [Emphasis added.]

many "dog bite" statutes;[50] yet the courts, excepting only those of Ohio,[51] consistently refuse to hold the dog owner liable under these statutes if the injured party's conduct amounts to assumption of the risk or to intentional provocation of the dog,[52] and in some cases, if the conduct amounts to contributory negligence.[53] Whether or not the North Carolina court would follow these states and read defenses into the North Carolina statute is speculative. But the North Carolina court has indicated, in at least one case,[54] that the only relevant questions in suits under the statute are first, is the defendant (in the county's suit against the dog owner) the owner of the dog, and second, is the damages award to the injured party reasonable in amount.[55] If this is the extent of the inquiry, then upon

[50] CAL. CIV. CODE § 3342; NEB. REV. STAT. § 54-601 (1960); R.I. GEN. LAWS ANN. § 4-13-16 (1956); TENN. CODE ANN. § 44-101 (1964); UTAH CODE ANN. § 18-1-1 (1953); W. VA. CODE ANN. § 19-20-13 (1966); WIS. STAT. ANN. § 174.02 (1957).

[51] Inasmuch as contributory negligence of plaintiff, as a defense to an action, presupposes the existence of negligence upon the part of defendant, and inasmuch as the liability of the owner or harborer of a dog to one proximately injured by such dog is predicated solely upon the statute . . . and not upon the negligence of the owner or harborer of such dog, contributory negligence of plaintiff, as such, is not a defense to an action for damages brought under the statute for injuries proximately caused by such dog.

Siegfried v. Everhart, 55 Ohio App. 351, 9 N.E.2d 891, 891 (1936). Dragonette v. Brandes, 135 Ohio St. 223, 20 N.E.2d 367 (1939).

[52] The comment of the California Court is typical: "In adopting section 3342 of the Civil Code, the Legislature did not intend to render inapplicable such defenses as assumption of risk or wilfully invited injury. Therefore, those defenses are available in all proper cases." Gomes v. Byrne, 51 Cal. 2d 418, 333 P.2d 754, 755 (Sup. Ct. 1959). See, *e.g.*, Vandecar v. David, 96 So. 2d 227 (Fla. Dist. Ct. App. 1957); Foy v. Dayko, 82 N.J. Super. 8, 196 A.2d 535 (1964); Nelson v. Hansen, 10 Wis. 2d 107, 102 N.W.2d 251 (1960).

[53] See, *e.g.*, Colby v. Lee, 83 N.H. 303, 142 Atl. 115 (1928); Foy v. Dayko, 82 N.J. Super. 8, 196 A.2d 535 (1964); Schraeder v. Koopman, 190 Wis. 459, 209 N.W. 714 (1926).

[54] Board of Comm'rs v. George, 182 N.C. 414, 109 S.E. 77 (1921).

[55] In a suit by the county commissioners against the dog owner, the dog owner unsuccessfully contended that the statute denied him his right to trial by jury. In holding the owner was not so deprived, the court stated:

Upon the trial [in the county's suit against the dog owner] it would be incumbent upon the commissioners to show by the preponderance of the evidence that the defendant was the owner of the dog, as well as the amount of damage; and it would be open to the defendant to rely upon failure of the plaintiff's proof and, if necessary, upon evidence offered in rebuttal.

Board of Comm'rs v. George, 182 N.C. 414, 418, 109 S.E. 77, 78-79 (1921). Presumably, the "evidence offered in rebuttal" can only be in rebuttal to the fact of ownership and to the amount of damage.

proof of the ownership of the dog and of the reasonableness of the amount of the damages, the dog owner's obligation to reimburse the county becomes absolute. No defense he could raise at common law against the injured party could bar recovery against him in a suit by the county. Similarly, in the injured party's suit against the county, the county would be totally unconcerned with whether or not the conduct of the injured party amounted to contributory negligence, assumption of the risk, or intentional provocation of the dog. Thus it seems that an injured party, unable to recover at common law because he assumed the risk or intentionally provoked the attack, would always elect[56] to sue under the statute in order to be compensated for his injuries. In turn the county would sue the dog owner who is now placed in the position of an insurer for the conduct of his dog, but only because the injured party elected to sue under the statute instead of the common law. Thus the statute becomes an avenue for the payment of claims uncompensable by common law standards and for the imposition of liability on the dog owner where the injured party voluntarily incurred his injury. Yet by interpreting the statute literally, no conclusion can be reached other than that it creates absolute liability.[57]

Therefore, because the counties to which the statute applies will continue to be called upon to pay claims of injured parties, and because the basis of liability of the dog owner is susceptible to conflicting interpretations, legislative or judicial clarification of exactly what was intended by the statute would seem to be in order. Although both interpretations advanced for the basis of liability of the dog owner result in the dog tax fund's being reimbursed for every claim paid out by the county (except where the dog owner cannot be found or where he is judgment-proof), the first interpretation, that the statute does not create strict liability, unlike the second, would not require the county to compensate the claims of parties voluntarily incurring their injuries. Arguably, the public purpose of such a statute would be more consistently served under the first

[56] Board of Comm'rs v. George, 182 N.C. 414, 109 S.E. 77 (1921), indicates that an injured party can elect to sue either at common law or under the statute.

[57] " 'Where the language of a statute or ordinance is clear and its meaning unmistakable, there is no room for construction, but we merely follow the intention as thus plainly expressed.' " Perrell v. Beaty Service Co., 248 N.C. 153, 160, 102 S.E.2d 785, 790 (1958). *Accord*, Siegfried v. Everhart, 55 Ohio App. 351, 9 N.E.2d 891 (1936).

interpretation, as parties would not be allowed to profit at public and private expense from their own intentional acts. A definitive determination of the uncertainties[58] now existing in the statute would allow more effective administration of the statute, would give the dog owner more adequate notice of the degree of responsibility placed on him by the statute, and would enable the county, because the basis of the dog owner's liability is made clear, to defend and prosecute more effectively suits under the statute.

SUSAN H. EHRINGHAUS

Torts—Rights of Servicemen under Federal Torts Claim Act

Of the enumerated exceptions to the Federal Tort Claims Act,[1] none have created more litigation than the judicially imposed bar to members of the armed forces prohibiting their suits against the United States for injuries incurred incident to service. Since 1950 when the Supreme Court handed down the decision in *Feres v. United States*,[2] the courts have dogmatically rejected such suits by servicemen.[3] With some degree of boldness, Judge Gray in the United States District Court for the Central District of California denied the government's motion to dismiss an action admittedly falling within the prohibition enunciated in *Feres*, i.e., actions "for injuries to servicemen where the injuries arise out of or are in the course of activity incident to service."[4] In this case, *Lee v. United States*,[5] Judge Gray reasoned that by its decisions in a series of recent cases the Supreme Court has vitiated its grounds for precluding actions by servicemen for injuries incident to service *wherein* the

[58] There are procedural uncertainties in the statute as well as substantive ones. The statute is silent on what would happen should the dog tax fund be insufficient to discharge all the claims coming before the county, as well as on the point in time at which the dog tax fund, after payment of claims, is released to the schools.

[1] 28 U.S.C. §§ 1346(b), 2671-80 (1964).

[2] 340 U.S. 135 (1950).

[3] *E.g.*, United Airlines, Inc. v. Wiener, 335 F.2d 379 (9th Cir. 1964) *cert. dismissed*, 379 U.S. 951 (1964) (servicemen travelling in line of duty on airline which collided with Air Force jet fighter); Buer v. United States, 241 F.2d 3 (7th Cir. 1956) (serviceman injured by negligence of army surgeon while in "sick in hospital" status); Kilduff v. United States, 248 F. Supp. 310 (E.D. Va. 1960) (serviceman's injury based on government's negligent failure to disclose results of physical examination).

[4] 340 U.S. 135, 146 (1950).

[5] 261 F. Supp. 252 (C.D. Cal. 1966).

injuries do not stem from activities that involve an official military relationship between the negligent government employee and the claimant. In *Lee*, plaintiffs alleged negligence by the Federal Aviation Agency, not part of the military, for causing the aircraft crash, and the resulting injuries. The historical development behind the *Feres* exception to Tort Claims Act liability takes on interesting significance in light of Judge Gray's conclusion that *Feres* is no longer a correct statement of the law.

The Supreme Court accepted the common law doctrine of sovereign immunity from suits by citizens early in its history.[6] The injustice of this doctrine was mitigated in a series of legislative acts granting relief.[7] Of special importance, the Tucker Act of 1887[8] waived sovereign immunity for actions "not sounding in tort." But until the enactment of the Federal Tort Claims Act in 1946, private bills in Congress provided the only means of compensation for citizens wrongfully injured by federal employees.[9] The Tort Claims Act waived the sovereign immunity of the United States from tort liability for injury or damages caused by negligence or wrongful act or omission of any employee of the government, while acting within the scope of his office or employment, under circumstances where the United States, if a private person, would be liable to the claimant in accordance with the law of the place where the act occurred.[10] The statute also grants authority for administrative settlement of claims of 2,500 dollars or less by the head of the federal agency affected.[11]

The statute precludes recovery in thirteen enumerated exceptions.[12] Among the excluded, were claims "arising in a foreign

[6] Gibbons v. United States, 75 U.S. (8 Wall.) 269 (1868); Chisholm v. Georgia, 2 U.S. (2 Dall.) 419 (1792).

[7] *E.g.*, Act of June 25, 1910, 36 Stat. 851, as amended, 28 U.S.C. § 1498 (1964) (waived immunity for patent infringement); Federal Employees Compensation Act, 39 Stat. 742 (1916), as amended, 5 U.S.C. § 751 (1964) (provided comprehensive benefits for injured federal employees); Public Vessels Act of March 3, 1925, 43 Stat, 1112, as amended, 46 U.S.C. §§ 781-90 (1964) (allowed libels in personam against United States for damage caused by its vessels).

[8] 28 U.S.C. §§ 507, 1402, 1491, 1496-7, 1501, 1503, 2071, 2072, 2411, 2501, 2512 (1964).

[9] See United States v. Muniz, 374 U.S. 150, 154 (1963).

[10] 28 U.S.C. § 1346(b) (1964).

[11] 28 U.S.C. § 2672 (1964).

[12] See 28 U.S.C. § 2680 (1964). Of the enumerated exceptions, § 2680(h) which bars recovery against the United States for intentional torts of its employees, such as assault, battery, and slander, is of particular significance.

country,"[13] and claims "arising out of combatant activities"[14] of the armed forces. Otherwise, the serviceman was not specifically excluded from benefits of the Act. During the years preceding enactment of the Tort Claims Act, a number of bills were introduced in Congress to waive the immunity of the government from general tort liability.[15] Most of these bills provided that cases covered by Federal Employees Compensation Act,[16] or the World War Veterans Act of 1924,[17] were excepted. The obvious intent was to exclude claims by federal employees or military personnel who were provided other statutory means of relief. Upon the enactment of the Tort Claims Act, this exception was omitted. It must be concluded that Congress was aware of this omission since the bill as originally introduced excluded any claim arising out of *activities* of the armed forces during time of war but was amended before passage to exclude only combatant activities.[18] The omission must mean either that servicemen were intended to acquire benefits under the Act, or that Congress believed such specification unnecessary in light of the generally accepted common law barring such suits. Legislative history of the Act provides no explanation for the omission.

The first case to reach the Supreme Court concerning the rights of servicemen to sue the United States for injuries incurred during military service was decided in 1948. This case, *United States v. Brooks*,[19] involved the death of one serviceman and injury to another in an automobile accident while on furlough. The injuries were caused by the negligence of a civilian employee of the Army driving a United States Army truck. The Court held that servicemen were permitted to bring suit against the government for injuries sustained while on authorized leave from duty and not incident to service. Justice Murphy, speaking for the Court, noted, "where the accident incident to the Brooks' service, a wholly different case would be presented."[20]

The "wholly different case" was presented to the Supreme Court

[13] 28 U.S.C. § 2680(k) (1964).
[14] 28 U.S.C. § 2680(j) (1964).
[15] See United States v. Brooks, 337 U.S. 49, 51-2 (1949); Note, 1 SYRACUSE L. REV. 87, 90-1 (1949).
[16] 39 Stat. 742 (1916), as amended, 5 U.S.C. § 751 (1964).
[17] 43 Stat. 607 (1924).
[18] See United States v. Brooks, 169 F.2d 840, 848 n.5 (4th Cir. 1948).
[19] 337 U.S. 49 (1949); 50 COLUM. L. REV. 827 (1950); 35 CORNELL L.Q. 233 (1949).
[20] 337 U.S. 49, 52 (1949).

one year later in *Feres v. United States.*[21] In *Feres,* the Court considered three cases[22] presenting a common issue of "whether the Tort Claims Act extends its remedy to one sustaining 'incident to the service' what under other circumstances would be an actionable wrong."[23] In *Feres,* the decedent perished by fire in an Army barrack while on active military duty. Negligence was alleged in allowing him to be quartered in barracks known or that should have been known to be unsafe because of a defective heating plant and in failing to assure an adequate fire watch. In affirming dismissal of the action the Court recognized that the enumeration of specified exceptions "might also imply inclusion of claims such as we have here,"[24] but felt the necessity to construe the statute to fit "into the entire statutory system of remedies against the Government to make a workable, consistent and equitable whole,"[25] to be an overriding consideration. The primary purpose of the Act was to provide a remedy for the remediless. This did not include servicemen who were provided other relief. The Court noting the statutory language, "The United States shall be liable . . . as a private individual under like circumstances . . . ,"[26] found no analogous circumstances to meet the statutory requisite. The liability assumed by the government is created by all the circumstances, "not that which a few of the circumstances might create."[27] Hence, the landlord-tenant circumstance in *Feres* could not be isolated from the broader sovereign-soldier relationship. Since the serviceman was not free to choose his location, the Court did not believe that Congress intended a cause of action for him which would fluctuate with the various state laws. The Court also noted the distinctly federal character of the relationship between a member of the armed service and his government.[28] The legal incidents of such relationship can be derived only

[21] 340 U.S. 135 (1950); 3 ALA. L. REV. 429 (1951); 31 B.U.L. REV. 221 (1951).

[22] Feres v. United States, 177 F.2d 535 (2d Cir. 1949); Jefferson v. United States, 178 F.2d 518 (4th Cir. 1949) (injury caused by negligence of army surgeon); United States v. Griggs, 178 F.2d 1 (10th Cir. 1949) (death of army officer through negligent medical treatment by army surgeons).

[23] 340 U.S. 135, 138 (1950).

[24] *Ibid.*

[25] *Id.* at 139.

[26] 28 U.S.C. § 2674 (1964).

[27] 340 U.S. 135, 142 (1950).

[28] The Court referred to its prior recognition of the relationship as "dis-

from federal sources and governed by federal authority. Further, the Court seemed strongly persuaded by the comprehensive benefits provided for the injured serviceman under prior statutes. In concluding, the Court held that: "The Government is not liable under the Federal Tort Claims Act for injuries to servicemen where the injuries arise out of or are in the course of activity incident to service."[29] It was this statement of the law that Judge Gray in *Lee v. United States*[30] felt was no longer authoritative.

In *Lee v. United States*,[31] two marines on active duty were being transferred by air from a California station to Viet Nam. The aircraft, operated by the Military Air Transport Service, United States Air Force, crashed in departure for the overseas flight. The two marines, and others, were killed. The plaintiffs made no charge against the Marine Corps or the Air Force, but alleged negligence on the part of the Federal Aviation Agency in operating, maintaining and controlling the departure of the aircraft from the ground and in giving inadequate terrain clearance information. The government moved to dismiss on the ground that, as a matter of law, the facts preclude recovery under the Tort Claims Act. This motion was denied.

First commenting on the lack of any language in the Tort Claims Act which would indicate that servicemen are to be deprived of the benefits of the Act in the circumstances in point, Judge Gray quoted from the decision in *United States v. Brooks* by Justice Murphy:

> We are not persuaded that "any claim" means "any claim but that of servicemen." . . . It would be absurd to believe that Congress did not have the servicemen in mind in 1946, when this statute was passed. The overseas and combatant activities exceptions make this plain.[32]

This argument appears less viable today. Accepting that the omission of any specified exception for servicemen may have indicated some Congressional intent to allow their suits, Congress has had ample time since the *Feres* decision in 1950, to correct a misinterpretation of the statute. Congress has remained silent since *Feres* con-

tinctly federal in character" in United States v. Standard Oil Co., 332 U.S. 301 (1947).

[29] 340 U.S. 135, 146 (1950).

[30] 261 F. Supp. 252 (C.D. Cal. 1966).

[31] *Ibid.*

[32] 337 U.S. 49, 51 (1949).

strued the Act disallowing servicemen's suits. In fact, the Act was amended in 1959 to add the thirteenth exception to the list.[33] No indication is evident that Congress is displeased with prior judicial construction of the Act. Judge Gray's inference of legislative intent to allow servicemen's suits does not seem to overcome the presumption of approval of the *Feres* prohibition of such suits found in seventeen years of Congressional silence.

Taking each of the three assigned grounds for the conclusion in *Feres* which would defeat the plaintiffs in *Lee*, Judge Gray rejected them in orderly succession as having been abandoned by later decisions. Following is a closer look at the respective arguments and a consideration of their validity.

1—To the argument that the serviceman already had a comprehensive system of relief and therefore was not intended to benefit from the Act, the court cited *United States v. Brown.*[34] In this case, a veteran receiving compensation for a service-connected injury to his knee, was further negligently injured by an operation performed in a Veterans Administration hospital. The *Brown* Court held that disability compensation under the veterans acts was not an exclusive remedy and would not preclude recovery under the Tort Claims Act. The Court distinguished the *Brown* facts from *Feres* in that the injury for which recovery is sought occurred when the claimant was not a member of the armed service. Hence, the "distinctly federal character"[35] of the relationship was lacking. Assuming that Congress might have intended to exclude recovery under the Act to servicemen injured while on active duty, the Court recognized that there was no blanket exclusion intended for claimants not members of the service at the time injured, who might be receiving some form of federal compensation. *Brown* was explained thusly, and specifically adhered to the *Feres* "incident to service" test.[36] The *Lee* court also cited *United States v. Muniz,*[37] in which two inmates of a federal penitentiary sued under the Tort Claims Act for injuries sustained due to the negligence of supervisory personnel. Relying on *Brown*, Chief Justice Warren in *Muniz* stated

[33] Act of August 18, 1959, 73 Stat. 389, 28 U.S.C. § 2680(n) (1964) (claims arising from the activities of federal banks).
[34] 348 U.S. 110 (1954).
[35] See note 28 *supra* and accompanying text.
[36] 348 U.S. 110, 113 (1954).
[37] 374 U.S. 150 (1963).

that "the presence of a compensation system, persuasive in *Feres*, does not of necessity preclude a suit for negligence"[38] under the Tort Claims Act. Two aspects of *Muniz* distinguish it from the *Lee* and *Feres* fact situations, and, to a degree, detract from the significance of the Chief Justice's statement. 1) The "distinctly federal character" of the sovereign-soldier relationship relied upon in *Feres* is lacking. 2) There was no compensation system available to Muniz.[39] Under the *Muniz* circumstances, recovery under the Tort Claims Act was the sole remedy available for the wrongful injury. Hence, the above quoted statement from *Muniz* was dictum.

Reconciling *Brown* and *Muniz* with *Feres* is made less difficult by the rationale of a case handed down by the Supreme Court on December 5th, 1966, only seven days before the *Lee* decision. This case, *United States v. Demko*,[40] held that the claimant who was receiving compensation for injuries sustained while an inmate in a federal penitentiary was precluded from recovery under the Tort Claims Act. The Court adhered to the rule laid down in *Johansen v. United States*,[41] that where "the government has created a comprehensive system to award payment for injuries, it should not be held to have made exceptions to that system without specific legislation to that effect."[42] *Demko* distinguished *Muniz* in that the claimant there was not eligible for the compensation received by Demko.[43] A dissent in *Demko* was based on the grounds that the benefits received by the claimant were too limited and that the statute providing compensation for prisoners was not sufficiently comprehensive.[44]

2—Judge Gray effectively countered the *Feres* argument that

[38] *Id.* at 160.

[39] *Ibid.* See note 43 *infra.*

[40] 385 U.S. 149 (1966). Judge Gray cited this case without comment. 261 F. Supp. 252, 255 (C.D. Cal. 1966).

[41] 343 U.S. 427 (1952). The Court in Johansen held that the existence of a remedy under the Federal Employees Compensation Act precluded a suit for damages under the public Vessels Act.

[42] 343 U.S. 427, 441 (1952).

[43] Demko was awarded $180 per month to start upon discharge from prison and to continue so long as the disability continued, under the Act of June 23, 1934, 48 Stat. 1211, as amended, 18 U.S.C. § 4126. The Act provides compensation for "injuries suffered in any industry or in any work activity in connection with the maintenance or operation of the institution where confined." Demko fell within this provision; Muniz did not.

[44] Mr. Justice White noted in the dissent that the compensation under the Act was permissive not mandatory, that compensation did not become a vested right, and that the amount rested within the discretion of the Attorney General. 385 U.S. 49, 155-6 (1966).

there were no analogous circumstances for a private individual's liability as a prerequisite to United States' liability by citing *Indian Towing Co. v. United States*.[45] There, the Supreme Court allowed recovery for damages resulting from the grounding of a tug due to the negligence of the Coast Guard in the operation of a lighthouse. In a subsequent decision, *Rayonier Inc. v. United States*,[46] the Court found that an injury caused by the negligence of firefighters employed by the government was actionable under the Tort Claims Act. In neither case did the activity, operating lighthouses for navigation and fighting forest fires, have "analogous circumstances" in the non-governmental area. The Court established that governmental liability under the Tort Claims Act does not require that the total circumstances under which the injury occurred be paralleled in private activity.[47] If the activity might conceivably be privately performed, liability may be imposed.[48]

3—As to the argument that the servicemen should not be left victim to the varying state laws where injuries occur inasmuch as he has no control over where his military duties might take him, Judge Gray again cited *Muniz*. Commenting that prisoners likewise have little discretion as to the state in which they dwell and hence might be prejudiced, the judge quoted Chief Justice Warren in *Muniz*, ". . . it nonetheless seems clear that no recovery would prejudice them even more."[49] It is significant to note that, in *Muniz*, recovery under the Tort Claims Act was the only alternative and the quoted statement was appropriate, but its validity is questionable when placed in the context of *Lee* wherein a comprehensive compensation system is available.

Judge Gray concludes from his survey of cases that the serviceman would not be precluded from recovery under the Tort Claims Act when the official activities of the negligent party and those of the injured parties are entirely unrelated. The decision implies agreement with the views of several Supreme Court opinions[50] that

[45] 350 U.S. 61 (1955). See Note, 70 HARV. L. REV. 134 (1956); Note, 54 MICH. L. REV. 875 (1956).

[46] 352 U.S. 315 (1957). See Note, 33 IND. L.J. 339 (1958); Note, 8 SYRACUSE L. REV. 277 (1957).

[47] See 352 U.S. 315, 318 (1957); 350 U.S. 61, 66-7 (1955).

[48] See 350 U.S. 61, 68 (1955).

[49] 374 U.S. 150, 162 (1963).

[50] United States v. Brown, 348 U.S. 110 (1954); Feres v. United States, 340 U.S. 135 (1950); United States v. Brooks, 337 U.S. 49 (1949).

the significance of the judicially imposed exception lies primarily in prohibiting suits involving "a battle commander's poor judgment, an army surgeon's slip of hand, a defective jeep which causes injury. . . ."[51]

The rule of recovery formulated by the *Brooks* and *Feres* decisions has left an uneasy sense of dissatisfaction and uncertainty. The case by case determination of whether the claimant's injury was incident to service has not proved to be an easy task. A naval reservist was allowed recovery under the Tort Claims Act for injury in a Navy aircraft accident enroute to the station where active duty was to begin.[52] The court found the activity was not incident to service. Recovery was allowed where an enlisted seaman on shore-leave was drowned because of the negligent maintenance of a swimming pool on a naval station.[53] The activity was found not incident to service. Injuries sustained through alleged negligence in a government hospital were found not incident to service, and recovery was allowed for a former member of the Women's Army Auxiliary.[54] An Army nurse was denied recovery on a finding that the injury was incident to service where the injury occurred in a Veterans Administration hospital four years after her discharge.[55] A sergeant injured while on a three day pass by an explosion demolishing his on-base quarters was denied recovery,[56] whereas recovery has been allowed where the injuries were sustained in quarters off-base.[57]

It is submitted that the *Lee* "official relationship" test will be subject to the same difficulty of application. At what point would the relationship take on sufficient "officialdom" to bar recovery? The rule would essentially prevent recovery under the Tort Claims Act only where there exists an official relationship between the activities of the negligent party and those of the injured party. To accept this rule would lead to undesirable discrimination. A large portion of the present military force is stationed in foreign countries. These servicemen would be automatically barred from re-

[51] United States v. Brooks, 337 U.S. 49, 52 (1949).
[52] Carroll v. United States, 247 F. Supp. 703 (E.D. Mo. 1965).
[53] Brown v. United States, 99 F. Supp. 685 (S.D. W. Va. 1951).
[54] Herring v. United States, 98 F. Supp. 69 (D. Col. 1951).
[55] Pettis v. United States, 108 F. Supp. 500 (N.D. Cal. 1952).
[56] Gursley v. United States, 232 F. Supp. 614 (D. Col. 1964).
[57] Sapp v. United States, 153 F. Supp. 496 (W.D. La. 1957).

covery by section 2680(k) of the Tort Claims Act if the injury occurred therein. Had the traffic controller's negligence in *Lee* caused the crash in Thailand instead of California, there would be no recovery. An increasing number of military personnel are engaged in combatant activities, and are thus precluded from recovery by section 2680(j) of the Act. Assuming wrongful injuries caused by federal employees without an official military relationship to the injured, it is difficult to infer Congressional intent to allow recovery for all servicemen except combatants or foreign-stationed personnel.

In light of the *Demko* decision barring recovery to a prisoner due to the comprehensive compensation system available to him otherwise, a brief examination of the compensation provided for the injured serviceman is helpful.

Title 38 of the United States Code is devoted entirely to the administration of veterans' benefits. The benefits include compensation for disability or death; hospitalization, medical treatment, and domiciliary care; burial allowance; loan guaranty for home, farm, business or trade; educational assistance and others. For the disabled veteran, the statute provides for compensation in accordance with the degree of disability.[58] The monthly compensation payments may range from 17 dollars for peacetime disabilities rated at 10 per cent,[59] to 600 dollars for total disability under certain circumstances.[60] Additional compensation provided for dependents of the disabled veteran may range from 20 dollars per month for a wife, to 68 dollars per month for a wife and three children plus 13 dollars for each child in excess of three.[61] Death benefits to a widow are determined by a formula based upon the serviceman's base pay.[62] Provisions are also made for children and dependent parents upon the death of a serviceman.[63] An immediate death gratuity equal to six months pay, not more than 3000 dollars nor less than 800 dollars, is payable to dependents.[64]

A service-connected injury severing the right arm of an Army Captain, age 30, would be rated as an approximate 80 per cent dis-

[58] 38 U.S.C. §§ 314, 334 (1964).
[59] 38 U.S.C.A. § 314(a) (Supp. 1966); 38 U.S.C.A. § 334 (1959).
[60] U.S.C.A. §§ 314(o), (p) (Supp. 1966).
[61] 38 U.S.C.A. §§ 314(o), (p) (Supp. 1966).
[62] 38 U.S.C. § 411 (1964) (establishes a monthly rate equal to $120 plus 12 per cent of the deceased husband's base pay).
[63] 38 U.S.C.A. §§ 413-16 (Supp. 1966).
[64] 10 U.S.C. §§ 1475-80 (1964).

ability by the Veterans Administration regulations.[65] Assuming that this is a peacetime injury and that the Captain has a wife and one child, age 6, disability payments per month would amount to 213 dollars until the child reached age 21, and 202 dollars thereafter.[66] Should the Captain live for his expected life span,[67] he will receive in excess of 98,000 dollars for disability payments alone. The death of this same Captain, assuming the above stipulations plus eight years in service, from service-connected injuries, would entitle his widow to compensation of 176 dollars per month.[68] Including an immediate death gratuity payment of 3000 dollars,[69] she can expect during her normal life expectancy[70] aggregate compensation in excess of 84,000 dollars. In both illustrations, hospitalization, medical treatment, and domiciliary care would be provided by the government.[71]

Comparing recovery under the Tort Claims Act with the statutory benefits available to the veteran, the Court in *Feres* took note that in the companion cases, Jefferson would receive approximately 35,000 dollars, and Grigg's widow in excess of 22,000 dollars, under the veterans compensation system at that time.[72] The widow's maximum recovery by wrongful death action was limited to 15,000 dollars by Illinois statute.[73] Thirteen states by statute still limit the amount of recovery for wrongful death actions.[74] The median maximum among these states is approximately 25,000 dollars. In the prior illustration of the Army Captain, a considerable amount in excess of this limitation would have been recovered under the veterans' acts without the accompanying expense of litigation.

The serviceman will receive compensation under the veterans' acts whenever the injury is determined to be service-connected, that

[65] 38 C.F.R. § 471(a) (1966).
[66] 38 U.S.C.A. §§ 314(h), (k), 315 (Supp. 1966; 38 U.S.C.A. §§ 334-35 (1959).
[67] See N.C. GEN. STAT. § 8-46 (Supp. 1965), where by the mortuary table therein, the Captain would have an expected life span of 40.39 additional years at age 30.
[68] 38 U.S.C.A. § 411 (1959); 37 U.S.C.A. § 203 (Supp. 1966).
[69] 10 U.S.C. § 1478 (1964).
[70] See N.C. GEN. STAT. § 8-46 (Supp. 1965), where at age 30, the widow would expect to live 40.39 years longer.
[71] 38 U.S.C. §§ 610-16 (1964).
[72] 340 U.S. 135, 145 (1950).
[73] *Ibid.*
[74] See Comment, 44 N.C.L. REV. 402, 426-7 (1966).

is, an injury sustained in the line of duty.[75] Any injury or disease incurred by military personnel while on active duty status is deemed to have been incurred in line of duty as long as it is not the result of his own wilful misconduct.[76] Active duty status expressly includes periods of authorized leave.[77]

The most compelling reason for not adopting the *Lee* extension of liability under the Tort Claims Act lies in the policy objective of arriving at a just, consistent, and rational rule to govern servicemen's suits. The only viable alternative to the present milieu of conflicting decisions and continuing litigation appears to be an acceptance of the availability of statutory compensation as an exclusive remedy for the serviceman. He is now provided with an adequate, fixed and certain scale of benefits for service-connected injury or death. In view of the special relationship between the sovereign and soldier, and the particular hazards of military life, the government has provided adequate protection against injury or death for military personnel. This protection is now provided without the expense and uncertainty of litigation under the Tort Claims Act. To hold that, where applicable, the statutory compensation system available to members of the armed services is their exclusive remedy would not prejudice their rights.

Congress has not spoken on the instant problem. Until it does, the courts are responsible for formulating a just and equitable rule of law. An appeal from the *Lee* decision will provide the 9th Circuit Court of Appeals an opportunity to apply the *Demko* rationale in the sovereign-soldier context. In light of the conflicts and problems resulting from the *Brooks* and *Feres* decisions and the approach recently applied in *Demko*, there is reason to believe that the Supreme Court may accept a rule formulated to exclude servicemen's Tort Claims Act suits where veterans' compensation is available to the claimant.

GERALD M. MAYO

[75] 38 U.S.C. § 101(16) (1964).
[76] 38 U.S.C. § 105 (1964).
[77] *Ibid.*

Trusts—The North Carolina Fiduciary Powers Act and the Duty of Loyalty

In 1965 the North Carolina General Assembly enacted the fiduciary powers act.[1] The act contains a list of thirty powers which are generally desirable in trust and estate management and which can be conveniently incorporated by reference into a trust instrument.[2] More important the draftsman is provided with a clear guide to powers available to the trustee which will eventually become well defined by case law. Use of the act will undoubtedly reduce the number of situations in which a trustee fails to act for fear of exceeding his authority and the necessity of applying to the court for instructions, often a time consuming and expensive process.[3] Despite these conveniences the act has created a number of problems[4] arising from the difficulty of striking a proper balance between the need for adequate powers in the trustee and adequate protection for the beneficiary. The purpose of this discussion is to analyze two of the North Carolina trustees' powers in light of tradi-

[1] N.C. GEN. STAT. §§ 32-25 to -27 (1966). For examples of similar legislation see ARK. STAT. ANN. §§ 58-114 to -116 (Supp. 1965) and TENN. CODE ANN. §§ 35-616 to -618 (Supp. 1966).

[2] The incorporation by reference type statute should be distinguished from a statute like the Uniform Trustee's Powers Act under which enumerated powers are automatically incorporated into all trust instruments unless specifically excluded. For a thorough analysis of the latter act see Horowitz, *Uniform Trustees' Powers Act*, 41 WASH. L. REV. 1 (1966) [hereinafter cited as Horowitz]. To the effect that the incorporation by reference type statute is inadequate to solve present day administrative problems see Fratcher, *Trustees' Powers Legislation*, 37 N.Y.U.L. REV. 627, 659 (1962).

[3] North Carolina is in accord with the well established rule that the courts will allow the trustee to deviate from the terms of the trust where due to circumstances not anticipated by the settlor compliance would defeat or substantially impair the purposes of the trust. RESTATEMENT (SECOND), TRUSTS § 167 (1959). *Accord*, Trust Co. v. Johnston, 269 N.C. 701, 153 S.E.2d 449 (1967); Bank v. Broyhill, 263 N.C. 189, 139 S.E.2d 214 (1964); Cocke v. Duke Univ., 260 N.C. 1, 131 S.E.2d 909 (1963); Blades v. Spitzer, 252 N.C. 207, 113 S.E.2d 315 (1960).

[4] N.C. GEN. STAT. § 32-26(b) (1966) creates an obvious problem which is beyond the scope of this discussion. Briefly, this section states that no power shall be exercised in such a manner as to deprive the trust or estate of an otherwise available tax exemption. First, it is not at all clear whether an exercise of power in violation of this provision would render the act of the trustee void or whether such exercise would constitute a breach of trust. More important it is not clear whether the Commissioner would honor this provision as a savings clause for federal estate tax purposes. See note 19 *infra* for a situation in which this becomes extremely important. For an analysis of a similar provision in the Uniform Trustees' Powers Act see Horowitz 13.

tional fiduciary principles of loyalty. Through this analysis the possible consequences of incorporation and the need for thoughtful draftsmanship will become apparent.

The requirement of loyalty of a trustee is derived from the most intense fiduciary relationship in our law.[5] Basically this duty requires the trustee to subordinate his personal interests and act solely in the interest of the beneficiary.[6] Whenever it appears that the trustee's personal interest may have been a factor, the courts have consistently fixed an extremely high and strict standard for his conduct.[7] The duty of loyalty requires, however, more than mere subordination of personal interest since it is unrealistic to assume that opportunity for personal benefit will be consistently disregarded. Thus the law attempts to eliminate all possibilities of personal profit by preventing the trustee from occupying a position in which his interest could possibly conflict with that of the beneficiary.[8] This requirement is not founded on a basic distrust of the trustee, but on the realistic premise that a man cannot possess total detachment from his own interests. The conflict may be so subtle that even the trustee is unaware of its effect on his judgment. Through the application of the rule of undivided loyalty the trustee has been prevented from buying trust property at his own sale,[9] selling his individual property to himself as trustee,[10] using the trust property for his own benefit,[11] depositing trust funds in its own banking department,[12] purchasing an adverse interest from a third party,[13] and receiving a commission on a transaction in performance of the trust.[14] North Carolina is in accord with the above principles[15] and in addition has codified the rule against self-dealing in a

[5] 2 SCOTT, TRUSTS § 170 (1956).
[6] *Ibid.*; BOGERT, TRUSTS § 95 (4th ed. 1963).
[7] See Scott, *The Trustee's Duty of Loyalty*, 49 HARV. L. REV. 521 (1936).
[8] See note 6 *supra.*
[9] 2 SCOTT, TRUSTS § 170.1 (1956).
[10] *Id.* § 170.12.
[11] *Id.* § 170.17.
[12] *Id.* § 170.18.
[13] *Id.* § 170.21.
[14] *Id.* § 170.22.
[15] See Trust Co. v. Johnson, 269 N.C. 701, 153 S.E.2d 449 (1967) where the court recognized "that one of the most fundamental duties of the trustee throughout the trust relationship is to maintain complete loyalty to the interests of his *cestui que trust.*" *Id.* at 711. The court continued by stating that "[i]n this jurisdiction there have been few inroads on the rule regarding the duty of loyalty by the trustee to the interests of the *cestuis que trust.*" *Id.* at 711. *Accord,* Morehead v. Harris, 262 N.C. 330, 137 S.E.2d

number of specific areas.[16]

A number of the powers set out in the North Carolina act are quite broad. These powers allow the trustee great leeway in the administration of the trust and permit him to occupy positions that are inconsistent with the fiduciary principles outlined above. Yet this fact does not in itself present a problem, for it is widely held that the undivided loyalty rule may be waived by the settlor and in certain circumstances by the beneficiary.[17] As will be pointed out below, the incorporation of at least one power in the North Carolina act will result in such a waiver by the settlor.[18] Since the draftsman can, however, refuse to incorporate a power if not in accord with the settlor's intent, and since even the broadest power may be desirable in certain situations, the new act can be utilized to its fullest extent with a minimum of problems through prudent and responsible draftsmanship. Yet despite the opportunity for selective incorporation, it should be recognized that as a practical matter the vast majority of trust instruments handled by corporate trustees in North Carolina incorporate the act *in toto*.[19] This fact makes it necessary to determine whether the powers analyzed are appropriate in prac-

174 (1964); Miller v. McLean, 252 N.C. 171, 113 S.E.2d 359 (1960); Trust Co. v. Barrett, 328 N.C. 579, 78 S.E.2d 730 (1953); Erickson v. Starling, 233 N.C. 539, 64 S.E.2d 832 (1951); Hatcher v. Williams, 225 N.C. 112, 33 S.E.2d 617 (1945); Williams v. Hooks, 199 N.C. 489, 154 S.E. 828 (1930); Carter v. Young, 193 N.C. 678, 137 S.E. 875 (1927); North Carolina R.R. v. Wilson, 81 N.C. 223 (1879); Freeman v. Cook, 41 N.C. 373 (1849).

[16] See N.C. GEN. STAT. §§ 36-26 to -30 (1966). The latter subsection which prevents a corporate trustee from purchasing its own stock should be kept in mind throughout the following discussion of the power of the corporate trustee to retain its own shares. Note that a number of these prohibitions cannot be waived by the settlor in the terms of the trust nor by the consent of the beneficiary. Purchase of its own stock by a corporate trustee is included in these non-waiver provisions. See N.C. GEN. STAT. §§ 36-40, 41 (1966). A court of competent jurisdiction may, however, relieve the trustee from these restrictions. N.C. GEN. STAT. § 36-42 (1966).

[17] See BOGERT, TRUSTS § 95 (4th ed. 1963); 2 SCOTT, TRUSTS §§ 170, 170.9 (1956).

[18] See note 30 *infra* and accompanying text.

[19] This fact was determined by personal communication with trust officers of well known North Carolina corporate trustees. Note, however, that a power or powers may be excepted due to potential adverse tax consequences. For example, the trustee is given a very broad power in N.C. GEN. STAT. § 32-27(29) (1966) to determine what is principal and what is income of the trust. This broadness would seem to jeopardize the qualification of the property for the marital deduction and consequently a number of corporate fiduciaries urge the exclusion of this power. See Treas. Reg. § 20.2056(b)-5(f)(4) (1958).

tically all situations and whether it can realistically be said that the settlor intended the consequences which flow from such incorporation.

The first power that may be incorporated permits the trustee:

> to retain for such time as the fiduciary shall deem advisable any property, real or personal, which the fiduciary may receive, even though the retention of such property by reason of its character, amount, proportion to the total estate or otherwise would not be appropriate for the fiduciary apart from this provision.[20]

The rule of undivided loyalty in respect to a retention power generally arises where the trust estate originally consists in part or in whole of the corporate trustee's own stock.[21] Unless authorized to retain such stock by the trust instrument, retention by the corporate trustee is a breach of trust due to the potential conflict of interest between the trustee and the beneficiary.[22] The possibility of an ac-

[20] N.C. GEN. STAT. § 32-27(1) (1966).

[21] Only the consequences of the incorporation of this provision as to the duty of loyalty will be discussed.

It should be noted, however, that in addition to loyalty restrictions the trustee is required to exercise a certain standard of care and will be held liable despite the power to retain if this standard is not met. See 3 SCOTT, TRUSTS § 230.1 (1956). Apparently North Carolina has adopted the "prudent man rule" as to investments and would apply it to acts of retention authorized by the above power. See Sheets v. Tobacco Co., 195 N.C. 149, 141 S.E 355 (1928) where the court relied on the traditional statement that the trustee

> is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to permanent disposition of their funds, considering the probable income as well as the safety of the capital to be invested. *Id.* at 152, 141 S.E. at 357, quoting from Harvard College v. Amory, 26 Mass. (9 Pick.) 446, 461 (1830).

For a review of early cases dealing with the investment power and the prudent man rule in North Carolina, see Comment, 14 N.C.L. REV. 160 (1936).

Although it is possible for the settlor to waive the requirement of reasonableness, it is doubtful that incorporation of this power would have such a result. The power gives the trustee broad discretion, but generally it is necessary to give "absolute" or "unlimited" discretion in order to waive this requirement. See RESTATEMENT (SECOND), TRUSTS § 187, comment *j* (1959). For a recent North Carolina case in which the prudent man rule was not applicable due to the grant of "sole" discretion to the trustee, see Lichtenfels v. Bank, 268 N.C. 467, 151 S.E.2d 78 (1966). In this case the court gave great weight to the fact that the power was expressly set out in the trust instrument. *Quaere* whether a power that is incorporated and thus made express should receive the same weight in light of the wholesale incorporation evident in North Carolina?

[22] BOGERT, TRUSTS AND TRUSTEES § 543 (2d ed. 1960); 2 SCOTT, TRUSTS § 170.15 (1956). See generally Annot. 47 A.L.R.2d 187 (1956); Annot. 157

tual conflict in this situation is obvious since the corporation's officers may hesitate, consciously or unconsciously, to sell the shares where such a sale might depress the market value of the stock.[23] Also the sale of the corpus may compete with the desire of the officers to sell their own stock if there is a limited market.[24] This reluctance to sell may be compounded where the voting power represented by such shares is in the control of the corporate trustee.[25] It is well settled, however, that the retention of such shares may be authorized by the settlor,[26] and there is little doubt that the above power of retention, if incorporated, would serve as such an authorization.[27] Even though this power does not specifically mention shares of the corporate trustee, the majority of courts hold that such a general authorization to retain original investments is sufficient to cover this situation.[28] It is said that since the settlor was aware that he owned such shares, it is reasonable to infer that he intended the general authorization to cover them.[29] The validity of this rationale seems questionable unless there is evidence that the corporate trustee informed the settlor of the potential conflict of interest created by such a power. It seems highly doubtful that the

A.L.R. 1429 (1945); Annot. 134 A.L.R. 1324 (1941); Scott, *Retention of Its Own Shares by a Corporate Trustee*, 57 HARV. L. REV. 601 (1944).

[23] See 2 SCOTT, TRUSTS § 170.15 (1956).

[24] See Hallgring, The Uniform Trustees' Powers Act and the Basic Principles of Fiduciary Responsibility, 41 WASH. L. REV. 801, 813 (1966). [hereinafter cited as Hallgring].

[25] See 2 SCOTT, TRUSTS § 170.15 (1956).

[26] RESTATEMENT (SECOND), TRUSTS § 170, comment *n* (1959), 2 SCOTT, TRUSTS § 170.15 (1956).

[27] There has been very little litigation in North Carolina involving powers of retention. However, the court did evidence a liberal attitude toward such a power in Young v. Hood, 209 N.C. 801, 184 S.E. 823 (1936). The testator desired that certain bank stock be retained by the corporate trustee and authorized such retention by an express provision in the trust instrument. By a subsequent merger with this bank the corporate trustee held its own stock under the trust. Since the trust did not originally include the trustee's own stock, it cannot be said that by the express authorization the testator intended to waive the rule of undivided loyalty. The court held, however, that the trustee was not subject to surcharge despite the decline in value of the stock. Although the testator did desire the retention of the stock, this case does not seem to be particularly well reasoned from a duty of loyalty standpoint since the conflict of interest arose subsequent to the creation of the trust.

The liberality of this decision alone would seem to indicate that North Carolina will follow the majority in construing a general authorization to retain original property. See note 26 *supra* and accompanying text.

[28] See note 26 *supra*.

[29] 2 SCOTT, TRUSTS § 170.15 (1956).

typical settlor intends to waive the rule of undivided loyalty in the normal situation, yet this is precisely the result of such an incorporation.[30] Waiver of this rule should not, however, be understood as allowing self-dealing by the trustee. Technically the only consequence of such waiver is that the trustee is allowed to occupy a position in which there is a potential conflict of interest. But even though the trustee is prevented from acting in his own interest despite waiver, the practical affect of the waiver places the beneficiary in a precarious position. The rule of undivided loyalty becomes sterile to a large extent where the trustee is permitted to occupy a position of potential conflict because of the difficulty encountered in proving or even in detecting self-dealing. It would be an unusual case indeed if the trustee could not make an after-the-fact explanation consistent with the duty of loyalty.

Thus in a very real sense the incorporation of the above power of retention places the corporate trustee in a totally unrestrained position. It is true that the large and well known corporate trustee employs internal sanctions to combat this danger.[31] Also there is no actual conflict in the usual case. Yet these facts do not justify incorporation of such a provision in all or even in the majority of trust instruments. Where the settlor desires that the corporate trustee hold its own stock,[32] it is likely that he will be more aware of the potential consequences of such incorporation and will communicate his desire for retention directly to the corporate trustee. But can it be realistically assumed that in every trust handled by a corporate trustee in North Carolina, the settlor was aware of a potential conflict of interest yet intended that the stock be retained whether or

[30] See Annot. 47 A.L.R.2d 187, 268 (1956); 90 C.J.S. TRUSTS § 248(e) (1955); see generally Scott, *Retention of Its Own Shares by a Corporate Trustee*, 57 HARV. L. REV. 601 (1944).

[31] For examples of suggested guidelines see Aartsen, *Statement of Policies on Conflict of Interest of Corporate Fiduciaries*, 103 TRUSTS & ESTATES 379 (1964). Note that Wachovia Bank & Trust Company has employed a safeguard through which the primary objections to a general authorization to retain are eliminated. Whenever it appears that Wachovia may have to hold its own stock in trust, it requests that a specific authorization to do so be placed in the trust instrument. This is done in spite of the incorporation of the general power to retain under the North Carolina Act. [This fact was determined by personal communication with a trust officer of the Wachovia Bank & Trust Company.]

[32] For example, the settlor may desire to give the corporate trustee such a power where the corporate trustee is a close corporation. In this situation retention of the stock may be very desirable for control purposes and would act much the same as a stock transfer restriction.

not administration of the trust is affected by self-interest? The answer is obvious. Thus it would seem to be arguable that in the loyalty area an incorporated power should not be accorded the same weight as a power expressly set out in the trust instrument.

By incorporation into the trust instrument the trustee may also be given the power

> to pay taxes, assessments, *compensation of the fiduciary*, and other expences incurred in the collection, care, administration, and protection of the trust or estate.[33]

Under this section the trustee is given powers essential to the efficient administration of the trust estate. Clearly the prudent draftsman would be expected to incorporate such powers. Yet the reference made in this power to compensation is somewhat questionable in light of North Carolina law.

Under the English rule the trustee is not entitled to any compensation for his services unless such compensation is expressly set out in the trust instrument.[34] The early North Carolina rule was in accord with the English view.[35] Under the modern rule in this country both corporate and individual trustees are entitled to compensation whether or not it is provided for in the trust.[36] The majority of states, including North Carolina, have enacted statutes that fix standards under which the trustee is to be compensated.[37] Those states that have no statute apply the general rule that the trustee is

[33] N.C. GEN. STAT. § 32-27(9) (1966). [Emphasis added]. This power is substantially the same as that set out in the UNIFORM TRUSTEES' POWERS ACT § 3(c)(20). For a detailed analysis and criticism of this power under the Uniform Act see Hallgring 816.

[34] 3 SCOTT, TRUSTS § 242 (1956).

[35] See Boyd v. Hawkins, 17 N.C. 160 (1832), where the court rejected the argument that trustees were entitled to compensation above reimbursement for expenses. The court recognized that compensation could be expressly stated in the trust instrument, but such amount was to be taken only as evidence that the parties did not intend the services to be gratuitious. Such express provision for compensation was to be disregarded and a reasonable amount set by the court. In this case the court feared that the "trustee would take what he pleased of the estate . . . under the name of compensation, and every abuse would follow." *Id.* at 174.

[36] BOGERT, TRUSTS § 144 (4th ed. 1963); 3 SCOTT, TRUSTS § 242 (1956).

[37] See N.C. GEN. STAT. § 28-170 (1966), which provides, in part, that

> [e]xecutors, administrators, testamentary trustees, collectors or other personal representatives or fiduciaries shall be entitled to commissions *to be fixed in the discretion of the clerk* not to exceed five per cent upon the amount of receipts . . . and upon the expenditures made in accordance with the law. . . .

Ibid. [Emphasis added.]

to receive reasonable compensation as determined by the courts.[38] Yet despite the traditional judicial and legislative control over fiduciary compensation, a reasonable interpretation of the above power results in the conclusion that it authorizes the trustee to fix his own compensation.[39] The existence of a statutory scheme dealing with fiduciary compensation in North Carolina raises a question as to whether a trustee could, under the above power, set his compensation above the statutory maximum of five per cent. Even if he could not, the question remains whether compensation set by the trustee within the maximum is entitled to an initial presumption of validity.[40] Seemingly *Trust Co. v. Waddel*[41] would require a negative answer to the latter question and perhaps to the former. The court stated in this case that "an executor has no right to fix and determine the compensation to be received by him."[42] From this case it seems to be well settled in North Carolina that unless set by the settlor, the maximum compensation to be received by a fiduciary is fixed by the statute with the actual amount determined only by the clerk of court.[43] In light of this decision it is difficult to see what affect incorporation of the above power could have in North Carolina. In addition the power is inherently violative of the duty of loyalty. It is impossible to conceive of a more obvious case of conflict between the interest of the trustee and that of the beneficiary. It has been appropriately asked: "What trustee will not judge that his own skills are beyond compare, his energies inexhaustible, and his difficulties the most vexatious?"[44] Even a mere presumption of validity becomes undesirable in light of the obvious self interest and vague standards applied to determine compensation.[45] It should be

[38] 3 SCOTT, TRUSTS § 242 (1956).

[39] See Horowitz 23.

[40] See Hallgring 818 where it is suggested that such prima facie validity may be found by a court supervising the exercise of this power under the Uniform Trustees' Powers Act.

[41] 237 N.C. 342, 75 S.E.2d 151 (1953).

[42] *Id.* at 345, 75 S.E.2d at 153.

[43] Note that this statement is not meant to cover situations in which the settlor or testator set the trustee's compensation in the terms of the trust. In such a situation compensation exceeding the statutory maximum would be allowed. See Trust Co. v. Waddell, 237 N.C. 342, 75 S.E.2d 151 (1953).

[44] Hallgring 818.

[45] Under the North Carolina compensation statute the clerk is to consider "time, responsibility, trouble and skill involved in the management of the estate. . . ." N.C. GEN. STAT. § 28-170 (1966).

For factors generally considered in the absence of a statute see RESTATEMENT (SECOND), TRUSTS § 242, comment *b* (1959).

noted, however, that as a practical matter this problem exists only as to the individual trustee. The corporate trustee generally uses a schedule of compensation that is written into the trust instrument.[46] The percentages in such a schedule are set primarily by competition and are well below the statutory maximum. It is clear that even if the corporate trustee had the power to set its compensation above that allowed by the statute, it would probably not do so due to the competitive restraint. But the same is not true of the individual trustee who could reward himself handsomely. Again, the trustee would have little difficulty showing reasonableness on an after-the-fact inquiry. In the final analysis it seems, however, that the North Carolina compensation statute and the difficulties encountered as to the duty of loyalty would prevent the trustee from fixing his own compensation despite incorporation of this power. If this is correct, the power should be deleted from the fiduciary powers statute. If not, North Carolina has departed sharply from duty of loyalty principles and the considerations deemed decisive against such a power in the vast majority of states.

The propriety of these powers[47] should also be considered in

[46] For example, the basic schedule used by the Wachovia Bank & Trust Company for trustees is as follows:

Annual principal charge: (Based on current market value)
$2.00 per $1,000 for the first $100,000
$1.00 per $1,000 for the next $400,000
$0.50 per $1,000 for all over $500,000
Annual income charge: (Based on income received)
5% or the first $10,000
2½% of all over $10,000

[47] Although the majority of the powers set out in the North Carolina Act are not overly broad and do not present fiduciary problems, there are at least two, other than those discussed above, that should be briefly mentioned. Both involve the duty of care.

N.C. GEN. STAT. § 32-27(4) (1966) allows the trustee to invest without diversification. This power is in conflict with the general rule that requires the trustee to spread investments so as to lessen the risk of loss. See 3 SCOTT, TRUSTS § 228 (1956). Thus the incorporation of this power would not seem desirable unless the settlor specifically intends to limit the field of investments.

N.C. GEN. STAT. § 32-27(24) (1966) enables the trustee to employ and compensate agents deemed necessary to advise or assist him and to do so without liability for any neglect provided the trustee selects and retains the agent with due care. It is not yet clear how far the trustee could go in delegating his duties to agents under this section. However, the power seems to be sufficiently broad to raise some question in light of the general rule that the trustee cannot delegate acts which he may reasonably be expected to perform. See 2 SCOTT, TRUSTS § 171 (1956). For a detailed analysis of the duty not to delegate and a criticism of a power similar to that in the North Carolina Act see Hallgring, 831.

light of the nature of the modern corporate trustee. The professional fiduciary is replacing the trusted family confidant as trustee in the modern business world. Despite a general realization that "the striving for profitability . . . should not obscure the traditional principles and ideals of trusteeship,"[48] the corporate trustee's relationship with the settlor and the beneficiary is becoming increasingly distant. The primary responsibility for maintaining the standard of loyalty clearly rests with the corporate trustee and most have set forth guidelines by which fiduciary principles are strengthened.[49] But it is also true that

> those entrusted with the responsibility for establishing legal rules must recognize that the trustee's pursuit of profit necessarily casts him in a commercial, arms-length, and to some degree adversary, relationship to settlors and beneficiaries; that under contemporary conditions, the maintenance of high standards of fiduciary conduct requires vigilance.[50]

The courts and legislatures in responding to the modern trustee's need for flexibility must not inadvertantly lift fiduciary restrictions. The same conditions and considerations which demand a broadening of the trustee's power also demand a strict concept of fiduciary responsibility. Without the latter the entire concept of the trust devise will fail. As one authority observed in speaking of an early financial era,

> [M]ost of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as the holy writ, that a man cannot serve two masters. . . . No thinking man can believe that an economy built upon a business foundation can permanently endure without some loyalty to that principle.[51]

This statement is equally applicable to the present trust era.

The problems discussed above are merely representative of those that may arise in the loyalty area. The majority of these problems can be eliminated by responsible and prudent draftsmanship and a general awareness on the part of the judiciary and legislature that such problems do exist. The broadness of these powers can be mitigated without placing undue restraint on the trustee by main-

[48] *Newsorama*, 103 TRUSTS & ESTATES 316 (1964).
[49] See note 31 *supra*.
[50] Hallgring 827.
[51] Stone, *The Public Influence of the Bar*, 48 HARV. L. REV. 1, 8-9 (1934).

taining high and clear standards under which they must be exercised. It is in the interest of the settlor, the trustee, and the beneficiary that a proper balance be maintained. Codification of such standards with special emphasis on the corporate trustee[52] would aid in achieving such balance.[53]

JOHN G. ALDRIDGE

Usury—Usury as Applied to Credit Transactions

In Biblical times[1] and at the early common law[2] the taking of any interest or compensation for the use of money, whether moderate or excessive, was considered usurious. Laws were later passed that allowed, but limited, the amount of interest a party could charge on a loan or forebearance of money.[3] In 1821, the case of *Beete v. Bidgood*[4] established the rule in England that a sale on credit was not a loan or forebearance of money and hence the laws against usury did not apply. This view was soon thereafter adopted in practically all the American courts.[5] This doctrine allows a vendor to charge one price for a cash transaction and a higher price for the sale of the same goods on credit. The fact that the credit price

[52] Due to the nature of the modern corporate trustee the need to set separate and higher standards is becoming greater. This need has been recognized to some extent by those authorities that require a higher degree of care for the corporate trustee. See RESTATEMENT (SECOND), TRUSTS § 174 (1959). Little attempt has been made, however, to set higher standards of loyalty due to the difficulty of framing such a standard. Thus day-to-day restraints are usually imposed by the corporate trustee itself. Yet despite this difficulty it seems that the loyalty concept merits more attention by law making bodies than it has received.

[53] As to the duty of care, both Tennessee and Arkansas have codified the "prudent man rule" as to investments and refer specifically to this standard in their powers acts. See ARK. STAT. ANN. § 58-302 (Supp. 1965); TENN. CODE ANN. § 35-320 (1955).

The Uniform Trustees' Powers Act in addition to adopting the prudent man rule in § 3(a), states in § 5(b) that if the duty of the trustee and his individual interests conflict in the exercise of a power, such power may be exercised only by authorization of the court. This restriction excludes, however, certain powers which are violative of fiduciary principles. For a criticism of these exclusions see Hallgring 812.

[1] Consolidated Police & Fireman's Pension Fund Comm'n v. Passiac, 23 N.J. 645, 652, 130 A.2d 377 (1957).

[2] Natonal Bank v. Mechanics' Nat'l Bank, 94 U.S. 437, 438 (1876).

[3] An Act Against Usury, 1570, 13 Eliz. I, c. 8, § IX.

[4] 7 Barn & Cress 453, 108 Eng. Rep. 792 (K.B. 1821).

[5] *E.g.*, Hogg v. Ruffner, 66 U.S. (1 Black) 38 (1861); Carolina Industrial Bank v. Merriman, 260 N.C. 335, 132 S.E.2d 692 (1963).

exceeds the cash price by a greater percentage than the legal rate of interest is of no consequence since the transaction is held to be outside the usury law. The courts predicated this doctrine on the basis that a vendor can charge whatever price he pleases. Furthermore, the vendee is free to accept or reject the vendor's offer. On the other hand, it is true a borrower in need of financial assistance has no choice but to accept a loan on the lender's terms.

The modern adherance to this doctrine is typified by the North Carolina Supreme Court in *Michigan Nat'l Bank v. Hanner*,[6] where Justice Branch, speaking for the court said: "The plaintiff's pleadings make out a sale and installment credit transaction, not a loan. Thus there can be no action for usury."[7]

In *Hanner* the defendant agreed to purchase an airplane from Graubart Aviation Inc. for a purchase price of 59,520 dollars and made a partial payment of 5,000 dollars by trading in a used plane. The defendant signed in blank a conditional sales contract and note and left them with Graubart. Later Graubart filled in the contract, raising the sales price to 69,500 dollars and adding a finance charge of 19,365 dollars. The defendant took possession of the plane in January 1963 and used it until April 1963 at which time he relinquished it to the vendor. The plane was then sold at public auction for 40,000 dollars and the plaintiff, who was an assignee[8] of the conditional sales contract and note, sued for the remainder of the unpaid purchase price and the unpaid finance charges. The defendant

[6] 268 N.C. 668, 151 S.E.2d 579 (1966).

[7] *Id.* at 673.

[8] There is a divergence of opinion as to whether a finance company who is an assignee of a conditional sales contract can be a holder in due course. For the proposition that it is not see Griffin v. Baltimore Savings & Loan Ass'n, 204 Md. 154, 109 A.2d 804 (1954). See also Commercial Credit Co. v. Childs, 199 Ark. 1073, 137 S.W.2d 260 (1940) discussed in 53 HARV. L. REV. 1200 (1940) and 20 U. CINC. L. REV. 123 (1951). These courts base their decisions on the theory that the finance company was a party to the transaction in and of itself; *cf.* Palmer v. Associate Discount Corp., 124 F.2d 225 (D.C. Cir. 1941) (relying on the agency theory). Typical of the view that a finance company under such conditions may be a holder in due course is White System of New Orleans v. Hall, 219 La. 440, 53 So. 2d 227 (1951).

A majority of the courts hold that the defense of usury is a real rather than a personal defense and even a holder in due course holds a usurious note subject to the usury defense. See Gilden v. Hearne, 79 Tex. 120, 14 S.W. 1031 (1890). This was reaffirmed in Lydick v. Stamps, 316 S.W.2d 107 (Ft. Worth Ct. Civ. App. 1958). The North Carolina Court seems to have adopted this view in Overton v. Tarkington, 249 N.C. 340, 106 S.E.2d 717 (1959) (the court spoke of *assignment* of the debt).

asserted the defense of usury in the nature of a counterclaim[9] for twice the amount he alleged had been charged in violation of usury laws. The North Carolina court held that the transaction was a sale on credit and not subject to the North Carolina usury law.[10]

Prior to *Hanner* the North Carolina court had enumerated the elements that must be present in order that there be a violation of the usury laws.[11] They are: (1) A loan expressed or implied, or a forebearance of money; (2) An understanding that the money lent was to be returned; (3) A greater rate of interest than the legal rate; and (4) A corrupt intent to take more than the legal rate of interest.[12] These seem to be the same essential factors that other courts look for in determining whether usury laws have been violated.[13]

Courts consistently state that they will look to the true nature of a transaction and not allow a subterfuge to conceal an exaction of more than the legal rate of interest.[14] The North Carolina Supreme Court found such a subterfuge in *Ripple v. Mortgage & Acceptance Corp.*[15] There an automobile manufacturer sold automobiles to a dealer who paid for them with his own draft and the titles to the automobiles were put in the name of the dealer. A mortgage company was designated as *vendor* on conditional sales contracts. The

[9] See Commercial Credit Corp. v. Robeson Motors, Inc., 243 N.C. 326, 90 S.E.2d 886 (1956). When sued on a contract a defendant may assert a counterclaim based on usury.

[10] 268 N.C. at 673, N.C. GEN. STAT. § 24-2 (1964) regulates the amount of interest that a party can charge. It states that the legal rate of interest in North Carolina is six per centum per annum and that the penalty for violation is the forfeiture of the entire interest and in case a greater rate of interest has been paid the person so paying may recover back twice the amount paid. N.C. GEN. STAT. § 53-43 (1964) allows commercial banks to charge interest in advance even though the debt is to be paid in installments. N.C. GEN. STAT. § 53-141 (1964) gives the same privilege to Industrial banks.

N.C. GEN. STAT. §§ 53-164 to -191 (1964) entitled "The Consumer Finance Act" provides for the licensing of small loan companies and sets out the amount of interest they can legally charge.

[11] Doster v. English, 152 N.C. 339, 341, 67 S.E. 754 (1910).

[12] The corrupt intent element is satisfied by the charging of a higher interest rate than the law allows. See Associated Stores Inc. v. Industrial Loan & Inv. Co., 202 F. Supp. 251 (E.D.N.C. 1962).

[13] *In re* Bibbey, 9 F.2d 944, 945 (8th Cir. 1925); Loucks v. Smith, 154 Neb. 597, 599, 48 N.W.2d 722 (1951); Hafer v. Spaeth, 22 Wash. 2d 378, 156 P.2d 408 (1945).

[14] *E.g.*, Dunn v. Midland Loan Fin. Corp., 266 Minn. 550, 289 N.W. 411 (1939).

[15] 193 N.C. 422, 137 S.E.2d 156 (1927).

court held that since the titles to the automobiles were never in the name of the mortgage company, it could not be a vendor, and the transaction could not possibly be a sale but was a loan of the purchase price.[16]

In comparing *Ripple* with *Hanner* it seems apparent that the North Carolina court concerns itself with form rather than substance when determining the true nature of the transaction in question. There is little substantive difference between a loan of 55,000 dollars with a charge of 30 thousand dollars interest and a sale of an item priced at 55,000 dollars and a subsequent additional charge of 30,000 dollars. No better statement concerning the lack of a substantial difference in such transactions can be found than the following by Judge Tomkins in *Failing v. National Bond & Inv. Corp.*[17] He said:

> In construing a statute, its purpose may not be ignored, its object should be the polar star of the court, when the course has become obscured by decisions where, manifestly, the port for the time, has been lost. . . . If it is the needy individual whose protection usury laws are inacted to guard, is the need of him who borrows that he may buy for cash, greater than his, who purchases on credit? . . . Tweedledum and tweedledee have no place in the law today, which professes to seek the truth; whose aim is justice.[18]

The attitude of the North Carolina court seems to be shared by the vast majority of the state and federal courts, which, though they state that they will examine the transaction, rarely find anything but a bona fide credit sale transaction.[19]

The courts of Arkansas[20] and Nebraska[21] have realized the futil-

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[16] *Id.* at 427.

[17] 108 Misc. 617, 6 N.Y.S.2d 67 (Rochester City Ct. 1938) *rev'd* at 12 N.Y.S.2d 260 (Monroe County Ct. 1938) *reversal aff'd* at 14 N.Y.S.2d 1011 (App. Div. 1939).

[18] 6 N.Y.S.2d at 71, 72.

[19] *E.g.*, Rose v. Wheeler, 35 P.2d 220 (Cal. 1934); Wyatt v. Commercial Credit Corp., 341 S.W.2d 348 (Mo. 1950); Yeager v. Ainsworth, 202 Miss. 747, 32 So. 2d 548 (1947) (proof of usury must be clear, positive and certain); Hafer v. Spaeth, 22 Wash. 2d 378, 156 P.2d 408 (1945) (a person may sell at any price and if bona fide it can not be usurious); Indian Lake Estates, Inc. v. Special Inv. Inc., 154 So. 2d 883 (Fla. Dist. Ct. App. 1963) (before there can be usury there must be a loan).

[20] 220 Ark. 601, 249 S.W.2d 973 (1952).

[21] 175 Neb. 483, 122 N.W.2d 528 (1963). There is some doubt that the Nebraska court actually vitiated the doctrine that a credit transaction is exempt from usury law because it specifically refused to overrule Grand

ity of attempting to distinguish between a credit sale and a loan or forebearance of money and treat the two as identical for usury purposes. Thus, any mark-up over the cash price will be treated as interest in these jurisdictions.[22]

The Commissioners on Uniform State Laws have recognized the anomaly that exists in the application of the usury laws and have undertaken an exhaustive study of the entire field of consumer credit for the purpose of drafting comprehensive uniform or model state legislation.[23] This study is at the request of the council of state governments. Substantial impetus for the study was provided by the bills entitled "Truth in Lending"[24] introduced in Congress by Senator Douglas of Illinois. Creditors would, under this legislation, be required to tell the consumer in terms that they can understand what they are paying for credit.[25] Generally speaking the Douglas Bill would require all consumer credit suppliers to state their finance charges in terms of an annual interest rate and in terms of a dollar amount. The proposed benefit to the consumer rests on the theory that there is an increasing amount of competition among creditors for consumer credit and in order for the consumer to benefit from this competition he must know which of two creditors offers the better credit price.

Conceding that a party may set one price for a cash transaction and a much higher price for the sale of the same goods on credit, it would seem, under basic contract principals, that the higher price must be agreed upon by both parties in order to consumate an enforceable contract. The decision in *Hanner* seems to be vulnerable

Island Fin. Co. v. Fowler, 124 Neb. 514, 247 N.W.2d 203 (1933) which established the doctrine in Nebraska. In the later case of G.M.A.C. v. Mackril, 175 Neb. 631, 122 N.W.2d 742 the Nebraska Court said: "Regardless of the term used this item is a charge for the loan of money or for the forebearance of a debt. Disguise it by any name or title we will, it is and remains interest." *Id.* at 636, 122 N.W.2d at 746.

[22] 220 Ark. at 607; 175 Neb. at 496. Other states have adopted a very strict view in regard to aggregation of interest which is contra to the North Carolina view set forth in note 7 *supra*. These states allow a bank to charge only the amount of interest which has been earned prior to the payment of each installment payment. A statement by the court in Dowler v. Georgia Enterprises, Inc., 162 Tenn. 59, 34 S.W.2d 445 (1930) is illustrative of this view. It said: "Payments are first applied to the discharge of interest accrued at the date of each partial payment." *Id.* at 62, 34 S.W.2d at 448.

[23] Buerger, *Project On Retail Installment Sales, Consumer Credit, Small Loans and Usury*, 18 PER. FIN. Q. 110 (1963).

[24] S. 2275 89th Cong., 1st Sess. (1965).

[25] S. 2275 § 4 89th Cong., 1st Sess. (1965).

on this point; but on closer examination, *Hanner* can probably be justified on the theory that the use of the plane for two months operated as an acceptance of the higher price.[26] In this factual respect *Hanner* differs from the practice indulged in by some retail stores. Under this practice a purchase is made of an item at a certain price and no mention is made of a credit price. The customer is then charged interest at rates as high as one and one-half per cent on the unpaid balance at the end of each month.[27] This is interest at the rate of eighteen per cent per annum. The legislation proposed by Senator Douglas would require that a creditor in an open end credit transaction (1) provide to the buyer a clear statement in writing, setting forth the simple annual percentage rate at which a finance charge will be imposed on the monthly balance and (2) furnish to each person at the end of each month a statement setting forth the simple annual percentage rate at which a finance charge has been imposed on the monthly balance.[28]

Usury statutes have, since their inception, been considered a valid exercise of the police power of the state.[29] The traditional justification rests in the theory that a needy borrower is compelled to accept the terms of a merciless lender. Therefore, the legislature protected the needy borrower against unconscionable rates of interest. It is submitted that a needy *consumer*, buying a necessity of life, is just as much at the mercy of the greedy merchant as a needy *borrower* seeking a loan from a voracious lender.

In the modern world the volume of credit buying is much greater than in the days of *Beete v. Bidgood*.[30] It has been estimated that the total volume of consumer credit, exclusive of home mortgage financing, approximates seventy billion dollars each year.[31] Consumer products comprise the largest portion of the total credit buying today and most of these products fall in the category of "necessities." The need seems apparent for some form of relief against

[26] 268 N.C. at 669. It should be noted that the appeal in *Hanner* was taken from the trial court's striking of the defendant's counterclaim based on usury; the enforceability of the original contract was probably not before the court.

[27] This charge is usually referred to as a carrying charge.

[28] S. 2275 89th Cong., 1st Sess. (1965).

[29] State *ex rel* Ornstine v. Cary, 126 Wis. 135, 140, 104 N.W. 792 (1905), *writ of error dismissed* 204 U.S. 669 (1906).

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

[31] Buerger, *Project On Retail Investment Sales, Consumer Credit, Small Loans and Usury*, 18 PER. FIN. Q. 110, 111 (1963).

the type of credit transaction discussed herein, either from the legislature or from the courts. The statutes against usury should be extended to include credit sale transactions. Until such statutory protection is afforded, a more realistic application of the "true nature of the transaction" rule would provide some degree of protection to the consumer.

BILLY R. BARR