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Notes

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NOTES

Antitrust Law—Reciprocal Price Information Exchanges

In *United States v. Container Corporation of America*,[1] the United States Supreme Court held that the exchange among corrugated container sellers of prices recently charged or quoted to buyers constituted a per se violation of section one of the Sherman Act.[2] The Court reasoned that the effect of the exchanges, in their market setting, had been to keep prices within a relatively narrow ambit, and that this interference with the price mechanism in the market was unlawful.

The method used was simple. When a seller was requested by a buyer to quote a price, he would sometimes ask his competitors who had sold or quoted prices to that buyer what their prices were or had been. There was no agreement that the seller seeking the last price or price quote from his competitor would not undercut it. The exchanges between the defendants were infrequent and the only compulsion to participate was the natural one that a seller would not be able to obtain price information from his competitors if he did not make it available to them. Moreover, industry prices had not increased despite rising labor and material costs. The industry, however, was competitive and, but for the exchanges, prices might have decreased.

Generally the effects of the dissemination of price information are determined by the economic setting[3] and the type of information, and thus the Court closely analyzed the economic conditions of the corrugated container industry. It found that the industry was controlled by a few dominant[4] sellers and that the product was homogeneous. Since each competitor's product was almost identical, price alone determined sales. Moreover, each box was individually made to size and shape to fill a specific order, with no standard unit that competitors could use to make

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[1] 89 S. Ct. 510 (1969).

[2] 26 Stat. 209, 15 U.S.C. § 1 (1964).

[3] *See generally* J. BAIN, INDUSTRIAL ORGANIZATION 27-36 (1959), *quoted in* H. BLAKE & R. PITOFSKY, ANTITRUST LAW 25-31 (1967) [hereinafter cited as BLAKE & PITOFSKY]; C. KAYSEN & D. TURNER, ANTITRUST POLICY 149-50 (1959) [hereinafter cited as KAYSEN & TURNER]; REPORT OF THE ATTORNEY GENERAL'S NATIONAL COMMITTEE TO STUDY THE ANTITRUST LAWS 325-26 (1955).

[4] For a factual breakdown of the concentration in the industry, see P. AREEDA, ANTITRUST ANALYSIS 531 (1967).

a price list. The industry was also characterized by ease of market entry and inelastic demand and there were competitive pressures from excess capacity and large buyers. These conditions resulted in uncertainty as to what sellers would charge and made the exchange of price information meaningful.

There were four primary factors then in the market situation of the container industry that served to facilitate interdependent pricing: (1) the general oligopolistic structure; (2) product homogeneity; (3) excess capacity; and (4) inelastic demand. The effect each factor has on the pricing structure must be understood before a critical appraisal of the Court's decision can be attempted.

Exchange of price information among oligopolists obviously can be a potent force for establishing price uniformity. By their nature, oligopolists must anticipate the reactions of their rivals more closely than participants in a more "perfectly competitive market," where power is fragmented and decisions are not based as much on what a seller's rivals are doing as what the seller himself is capable of doing. Uniformity of action in the oligopolistic industry is more easily arranged and enforced without resort to actual agreement. Hence, any agreement is harder to detect because of this natural tendency towards price uniformity. Proof of combination or conspiracy without actual agreement is also difficult, so assuring compliance with the antitrust laws by oligopolists necessarily becomes harder.

Interdependent pricing is further facilitated in industries that produce homogeneous products. Buyers are not persuaded by attempts at differentiation. Competition in quality or special appeal is eliminated, leaving price as the only uncertain factor a competitor must consider in anticipating his rivals' reactions.[5] Homogeneity encourages the tendency not to reduce prices because the seller knows his reductions will be automatically met by his competitors.[6]

Cöoperation to defeat the market mechanism is more likely in industries characterized by excess capacity because there is greater incentive to overcome that adverse economic condition.[7] Industries dealing in products for which there is an inelastic demand facilitate interdependent pricing because the buyer has to place his order on an immediate need

[5] BLAKE & PITOFSKY 28.

[6] Adelman, *Effective Competition and the Antitrust Laws*, 61 HARV. L. REV. 1289, 1329 (1948) [hereinafter cited as Adelman].

[7] 89 S. Ct. at 513 n.4. *See also* Adelman 1328.

basis.[8] Price changes would, therefore, neither increase nor decrease demand. Thus, there is less pressure to cut prices.

There are economic factors in the box industry that might have retarded the otherwise natural tendency towards oligopolistic interdependent pricing: (1) ease of market entry, (2) high fixed costs, and (3) an individualized product. Ease of market entry generally diminishes the effectiveness of oligopolists' efforts to maintain noncompetitive pricing. If entry does not require a large investment and large profits are prevalent, new businessmen are attracted to the industry and the oligopolists' share of the market and their profits are thus reduced.[9] But even this characteristic was turned against the defendants in *Container Corporation.* New entrants were indeed attracted to the industry,[10] despite its excess capacity. Businessmen, however, would not normally invest in an industry with excess capacity unless there were some special attraction to do so—for example, an unusually high rate of return. The Court could thus infer that the defendants' activities had operated to maintain prices at a normally unexpected level and thus attracted the new entrants. Furthermore, although new entrants usually cause periods of price instability in any market,[11] the Court noted that prices in the container industry had remained relatively stable. These two factors indicated that there was some outside force operating to stabilize prices and contributed to the "irresistable inference" that the exchanges of price information had an anticompetitive effect.[12]

High fixed costs of operation (as opposed to low initial capital investment) can also have a detrimental effect on noncompetitive oligopoly pricing. In industries with high fixed costs, sales gains give an extra boost to profits because the overhead cost can be spread over the expanding sales. Where the commodity is homogeneous, however, sales gains can be achieved only through off-list selling, secret rebates and other devices by which prices are secretly cut. The incentive to use these devices becomes even greater when high fixed costs are coupled with excess capacity as in the corrugated container industry. The individualized nature of the product can make price cuts more difficult to detect and therefore en-

[8] Brief for Appellant at 28, United States v. Container Corp. of America, 89 S. Ct. 510 (1969) [hereinafter cited as Brief for Appellant].

[9] BLAKE & PITOFSKY 29-30.

[10] 89 S. Ct. at 512.

[11] BLAKE & PITOFSKY 31.

[12] *See* 89 S. Ct. at 512.

courage departure from noncompetitive pricing. When uncertainty is introduced into the market in this manner, the stability of the oligopolists' control is disturbed.

However, if complete knowledge of current individual prices offered to specific customers is introduced into a noncompetitive oligopoly pricing situation, such as the corrugated container industry, the last doubt as to a competitor's prices will be eliminated. Incentive to lower prices is vastly reduced because the seller knows that lowering his prices will only bring him the same share of the market at a lower return.[13] Price uniformity becomes even more probable. Also eliminated is the buyer's option to withhold price information, thus injecting additional uncertainty into the market that might stimulate price competition based on competitors' individual capabilities.[14] In no instance has the Court sanctioned dissemination of information that specifically identified the customer who received a certain price.[15]

The Supreme Court in the past has not been unaware of the dangers of coöperation among oligopolists to eliminate those uncertainties in their markets that undermine interdependent pricing. *Sugar Institute, Inc. v. United States*[16] involved a somewhat similar economic situation. The sugar industry was dominated by a few sellers, and its product was homogeneous, but not individualized. Excess capacity and high fixed costs had led to the use of off-list pricing and secret rebates. The members of the Institute agreed to abide by published price lists. By eliminating off-list pricing, the members had removed the only possible uncertainty left in their market and the tendency towards price uniformity was greatly enhanced. The Court held the agreement violated the Sherman Act.[17] The second example of the Court's concern about the elimination of market

[13] See text at note 6 *supra*.

[14] Brief for Appellant 34.

[15] *See, e.g.*, Maple Flooring Mfrs. Ass'n v. United States, 268 U.S. 563 (1925); United States v. American Linseed Oil Co., 262 U.S. 371 (1923); American Column & Lumber Co. v. United States, 257 U.S. 377 (1921).

[16] 297 U.S. 553 (1936).

[17] We have noted that the fifteen refiners, represented in the Institute, refine practically all the imported raw sugar processed in this country. They supply from 70 to 80 per cent, of the sugar consumed. . . . Another outstanding fact is that defendants' product is a thoroughly standardized commodity. In their competition, price, rather than brand, is generally the vital consideration . . . . The fact that, because sugar is a standardized commodity, there is a strong tendency to uniformity of price, makes it the more important that such opportunities as may exist for fair competition should not be impaired.

Sugar Inst., Inc. v. United States, 297 U.S. 553, 600 (1936).

uncertainties to implement noncompetitive pricing is found in its decisions in the basing point system cases.[18] Again the industries involved were characterized by excess capacity, high overhead and a standardized product that encouraged the use of secret rebates. There were significant price variations resulting from the varying freight charges. By refusing to sell FOB and by quoting railroad freight charges exclusively, the nonequidistant sellers were able to match their competitors' prices more easily. The purpose of basing point and other similar systems was "to eliminate a kind of uncertainty that is a potent force disrupting stable noncompetitive oligopoly pricing."[19] Basing point systems agreements have been condemned by the courts as "price fixing."[20] Both examples indicate that the Court believes agreements designed to eliminate uncertainty and not having any dominant proper purpose should be condemned as per se violations of the antitrust laws.[21] Other attempts to remove the uncertainties remaining in a market by coöperative dissemination of price information have been considered anticompetitive efforts rather than attempts to make competition more effective.[22]

The defendants in *Container Corporation* argued that the purpose of the exchanges was to make competition more effective. Relying on

[18] FTC v. Cement Inst., 333 U.S. 683, 696-700, 709-17 (1948); Sugar Inst., Inc. v. United States, 297 U.S. 553, 589-93 (1936); Fort Howard Paper Co. v. FTC, 156 F.2d 899 (7th Cir. 1946); Milk & Ice Cream Can Inst. v. FTC, 152 F.2d 478 (7th Cir. 1946); United States Maltsters Ass'n v. FTC, 152 F.2d 161 (7th Cir. 1945).

[19] Turner, *The Definition of Agreement Under the Sherman Act: Conscious Parallelism and Refusals to Deal*, 75 HARV. L. REV. 655, 674 (1962). *See also* Adelman 1327-47.

[20] *See* cases cited note 18 *supra.*

[21] See generally KAYSEN & TURNER 150.

> But in markets where oligopolistic elements are present, some ignorance and uncertainty about the behavior of rivals is an important competitive element in the market, since it prevents "rational" oligopolistic calculation leading to joint maximization of profits.

Id.

[22] See Morton Salt Co. v. United States, 235 F.2d 573 (10th Cir. 1956) (formula pricing); C-O-Two Fire Equip. Co. v. United States, 197 F.2d 489 (9th Cir. 1952) (agreed prices); United States v. American Body & Trailer, Inc., CCH 1958 Trade Cas. ¶ 69,063 (W.D. Okla. 1958); United States v. Garden State Retail Gas. Dealers Ass'n, Inc., CCH 1956 Trade Cas. ¶ 68,493 (D.N.J. 1956) (agreed list prices); United States v. Electrical Solderless Serv. Connector Inst., CCH 1940-43 Trade Cas. ¶ 56,081 (S.D.N.Y. 1941); United States v. Stevenson, Jordan & Harrison, Inc., CCH 1940-43 Trade Cas. ¶ 56,061 (S.D.N.Y. 1941) (estimated prices). *Cf.* Maple Flooring Mfrs. Ass'n v. United States, 268 U.S. 563 (1925) (past prices permissible); Pevely Dairy Co. v. United States, 178 F.2d 363 (8th Cir. 1949); United States v. National Container Ass'n, CCH 1940-43 Trade Cas. ¶ 56,028 (S.D.N.Y. 1940).

Cement Manufacturers Protective Association v. United States,[23] they pointed out specifically that the exchanges were an attempt to protect themselves from buyers who misquoted offers from other competitors. But their argument can be dismissed on three grounds. First, as the Court pointed out, the cases are factually distinguishable.[24] In *Cement* the sellers exchanged information as to what orders had been filled to protect themselves from fraudulent inducements to deliver more cement than a contractor needed for a specific job. The defendants in *Container Corporation* had no legal right to get the correct price from the buyers. No tort had been committed by the buyers. Second, the defendants already had manuals which enabled them to calculate their competitors' prices,[25] and if they did not want to sell at as low a profit margin as their competitors, they did not have to. Third, it is now clear that the Court does not condone conspiracy to overcome competitive evils, or unethical conduct on the part of competitors or customers who use methods that would otherwise be per se violations of the antitrust laws.[26]

The Supreme Court's finding that the exchanges constituted a violation of the antitrust laws is not surprising. Past precedent supported if not compelled the outcome. The application of the per se rules was, however, an additional step.[27] Generally, the application of a per se rule depends upon a finding that the activity usually has bad effects, that good effects are rarely present and hard to prove, and that there is thus little need to examine effects or invite litigation over them. The per se rule is applied when the Court feels that the defendant should not be allowed to deny that which logic and experience indicate is the principle purpose of the activity. The difference between gains and losses from making conduct per se illegal[28] and the concomitant administrative advantages must justify

[23] 268 U.S. 588 (1925).

[24] 89 S. Ct. at 511.

[25] *Id.* at 512.

[26] Fashion Orig. Guild of Amer., Inc. v. FTC, 312 U.S. 457 (1941); United States v. Socony-Vacuum Oil Co., 310 U.S. 150 (1940); Sugar Inst., Inc. v. United States, 297 U.S. 553 (1936).

[27] The per se rule was not applied in Cement Mfrs. Protective Ass'n v. United States, 268 U.S. 588 (1925); Maple Flooring Mfrs. Ass'n v. United States, 268 U.S. 563 (1925); United States v. American Linseed Oil Co., 262 U.S. 371 (1923); American Column & Lumber Co. v. United States, 257 U.S. 377 (1921).

[28] Northern Pac. Ry. Co. v. United States, 356 U.S. 1 (1958); International Salt Co. v. United States, 332 U.S. 392 (1947) (tying arrangements); Fashion Orig. Guild of Amer., Inc. v. FTC, 312 U.S. 457 (1941) (group boycotts); United States v. Socony-Vacuum Oil Co., 310 U.S. 150 (1940) (price fixing); Addyston Pipe & Steel Co. v. United States, 175 U.S. 211 (1899) (tying clauses).

any arbitrariness involved.[29] In *Container Corporation*, the gain derived from making the price exchanges illegal was the elimination of a method used by already powerful oligopolists to remove one of the last obstacles to noncompetitive pricing in a market ideally receptive to such pricing. The oligopolists are denied a method by which they could interfere with the independent operation of the price mechanism.[30] Against this gain must be balanced any loss of potential benefit. The defendants do lose an easy method of determining which of their customers are misquoting prices to them. But since sellers are supposed to make independent decisions as to price based on their own costs and capabilities, this loss seems insignificant.[31]

In his dissent, Mr. Justice Marshall asserted that the per se rule should not be applied because the ease of market entry in the box industry would preclude the success of any anticompetitive activities.[32] His approach seems unrealistic for several reasons. First, competitors would still be controlling prices within the margins set by both the competitive price and by what they could get noncompetitively without inducing entry. Second, there is a lag between the time prices get high enough to induce entry and the time the entry actually takes place. Competitors, by careful manipulation, may exploit this time lag to make profits, then cut prices back in time to discourage new entry. Third, why should the Court depend on the second line defense of the economic mechanism, when the activity is unlawful? Fourth, the pressures created by ease of market entry are more than counterbalanced by the factors facilitating interdependent pricing. Fifth and last, the finding by the majority that price competition had been held within a narrow ambit despite new entries into the market indicate that Mr. Justice Marshall's hoped for effects had not and would not take place. New entrants would realize that the policy in the industry of buyers splitting orders among the lowest bidders would result in their maintaining their same share of the market at a lower return.

[29] The administrative advantages of per se rules are three: relative clarity, self-enforcement, and less need for litigation to achieve a given level of enforcement. KAYSEN & TURNER 142-43.

[30] Irrefutable precedent for the application of the per se rule for that purpose is found in the famous footnote 59 to United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 224 n.59 (1940), the language of which sounds peculiarly applicable to this case.

[31] *Container Corporation* represented an excellent opportunity for the Court to set down its policy. This was not a treble damage suit and the defendants did not stand to lose financially.

[32] 89 S. Ct. at 515 (dissenting opinion).

Container Corporation indicates that the Supreme Court is acutely aware of the economic setting in which the cooperative activities of businessmen take place. The Court is particularly insistent that oligopolists, because of the tremendous control they already have over the market, the natural tendency to price uniformity in oligopolistic industries, and the advantageous position they are in to defeat the competitive processes, not be allowed to remove any of the uncertainties that prevent them from obtaining even firmer control of the market. The corrugated container industry was ideally conducive to oligopolistic manipulation, except for the uncertainty created by the individualized nature of the product. The exchanges of price information eliminated that uncertainty. The Supreme Court was unwilling to allow the defendants, already rich in power, that additional luxury.

BEN F. TENNILLE

Arbitration—The Arbitrator's Duty to Disclose Past Business Relationships With a Party

"[W]here your treasure is, there will your heart be also."[1] This generally recognized element of human nature—that a man will be partial toward his own self-interest—is the reason for the rule that "no man shall be a judge in his own cause."[2] Acceptance of society's insistence that disputes among its members be resolved through the use of a judicial process, rather than through the use of violence or other forms of "self-help," depends to a great extent on the evident fairness and impartiality of the judicial system.[3] In the leading case of *Tumey v. Ohio*,[4] the Supreme Court held that it was a violation of due process to subject a defendant's liberty or property "to the judgment of a court the judge of which has a direct, personal, substantial, pecuniary interest in reaching a conclusion against him in his case."[5] In *Tumey*, the defendant was tried and convicted by the village mayor, who received additional compensation from all those tried by him only if they were found guilty. The Supreme

[1] *Matthew* 6:21.
[2] Dr. Bonham's Case, 8 Co. 113b, 77 Eng. Rep. 646 (C.P. 1610).
[3] *See* Hart & McNaughton, *Evidence and Inference in the Law*, in THE HAYDEN COLLOQUIUM ON SCIENTIFIC CONCEPT AND METHOD 51-56 (1958).
[4] 273 U.S. 510 (1927).
[5] *Id.* at 523.

Court reversed the defendant's conviction; it did not matter that there was no evidence of actual bias against the defendant:

> [T]he requirement of due process of law in judicial procedure is not satisfied by the argument that men of the highest honor and the greatest self-sacrifice could carry it on without danger of injustice. Every procedure which would offer a possible temptation to the average man as a judge to forget the burden of proof required to convict the defendant, or which might lead him not to hold the balance nice, clear and true between the State and the accused, denies the latter due process of law.[6]

The extent of the judge's self-interest needed to constitute a denial of due process cannot be defined with precision.[7] "Circumstances and relationships must be considered."[8] But "the administration of justice should reasonably appear to be disinterested as well as be so in fact."[9]

The law regarding disqualification of judges because of self-interest applies equally to administrative adjudicators.[10] In both the administrative and judicial setting, the law forces the parties to accept the findings and judgment of the adjudicator; their right to a fair and impartial hearing is guaranteed by the due process clause of the Constitution.[11] A related, but different, problem regarding impartiality is presented when parties by agreement go outside the judicial system for settlement of their disputes, as in arbitration, where the constitutional right of a fair trial would not be applicable.[12]

"Arbitration . . . is a process by which parties voluntarily refer their disputes to an impartial third person, an arbitrator, selected by them for a decision based on the evidence and arguments to be presented before the arbitration tribunal."[13] Protection against a partial arbitrator must come either from the arbitration agreement itself, or from an applicable statute.[14]

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[6] *Id.* at 532.

[7] *See In re* Murchison, 349 U.S. 133 (1954).

[8] *Id.* at 136.

[9] Public Util. Comm'n v. Pollak, 343 U.S. 451, 466 (1952) (statement of reasons for self-disqualification by Mr. Justice Frankfurter).

[10] *See generally*, K. DAVIS, ADMINISTRATIVE LAW TREATISE § 12.03 (1958); *see also* Note, *Administrative Law—Bias: "No Man Shall Judge His Own Cause,"* 47 N.C.L. REV. 677 (1969).

[11] U.S. CONST. amend. XIV, § 1.

[12] *See* Bernhardt v. Polygraphic Co. of America, 350 U.S. 198, 203 (1955).

[13] M. DOMKE, THE LAW AND PRACTICE OF COMMERCIAL ARBITRATION § 1.01, at 1 (1968). *See* W. STURGES, COMMERCIAL ARBITRATIONS AND AWARDS (1930).

[14] See discussion and cases cited in M. DOMKE, *supra* note 13, § 33.02.

In *Commonwealth Coatings Corp. v. Continental Casualty Co.*,[15] a subcontractor had sued the sureties on the bond of the prime contractor for money allegedly due for a painting job. The painting contract included an agreement to arbitrate such controversies.[16] Each party named one arbitrator, and these two selected the third. The third arbitrator, owner of an engineering firm that provided services to construction companies, had in the past done business with the prime contractor involved in the dispute. The panel voted unanimously in favor of the prime contractor.

The subcontractor challenged the award in the district court on grounds, *inter alia*, that it did not know and had not been informed by either the "neutral" arbitrator or the prime contractor of these previous dealings between them. There was no contention that the arbitrator was not entirely fair and unbiased. The district court refused to set aside the award[17] and the court of appeals affirmed.[18] The Supreme Court granted certiorari[19] and a divided Court reversed the lower courts and vacated the arbitration award.[20]

The United States Arbitration Act[21] governed the controversy in this

[15] 393 U.S. 145 (1968).

[16] The arbitration agreement in the contract read as follows:

> If any question of fact shall arise under this contract, either party hereto may demand an arbitration by reference to a Board of Arbitration, to consist of one person selected by Contractor, and one person selected by Sub-contractor, these two to select a third, and in case these two fail to select a third within three days, he shall be named by the Architect or his authorized representative. In case either Contractor or Sub-contractor fails to name an arbitrator within three days after requested to do so, the Architect, or his authorized representatives, shall name an arbitrator to represent the party so failing to name one. The written decision of any two of this Board shall be final and binding on both parties hereto. Each party shall pay one-half of the expenses of such reference. Arbitration of a demand or decisions by the Architect or Owner shall be made within 5 days following notification to Sub-contractor of such demand or decision, otherwise Sub-contractor shall be bound thereby, unless the Owner shall agree to arbitration after that period. Provided, nothing contained herein shall excuse Sub-contractor from completion of the work in the manner provided in this contract nor shall the pendency of any dispute or arbitration proceeding excuse any delay, deficiency, default, or noncompliance therewith.

Quoted in Brief for Petitioner at 4-5 and Brief for Respondent at 7-8 n.5, Commonwealth Coatings Corp. v. Continental Cas. Co., 393 U.S. 145 (1968).

[17] The decision by the United States District Court for Puerto Rico is not reported.

[18] Commonwealth Coatings Corp. v. Continental Cas. Co., 382 F.2d 1010 (1st Cir. 1967).

[19] Commonwealth Coatings Corp. v. Continental Cas. Co., 390 U.S. 979 (1968).

[20] 393 U.S. 145 (1968).

[21] 9 U.S.C. §§ 1-15 (1964).

case.[22] Section 10 of this act denotes the reasons for which an award may be vacated.[23] The Court felt that the provisions allowing vacation of the award where it was "procured by corruption, fraud, or undue means" or "where there was evident partiality . . . in the arbitrators" showed an intent on the part of Congress that arbitration be impartial.[24] While there was no charge that the third arbitrator was guilty of fraud or bias or that he had any improper motives, the failure to disclose the past business relationship with one party violated "the strict morality and fairness Congress would have expected on the part of the arbitrator and the other party in this case."[25]

The Court reasoned that the constitutional basis of the rule in *Tumey*[26] should not prevent its application to non-judicial adjudication that is governed by statutory language embodying the same concept of impartiality.[27] A rule of the American Arbitration Association[28] providing for disclosure by arbitrators of past relationships with parties, as well as

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[22] 393 U.S. at 146-47.

[23] In either of the following cases the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration—
(a) Where the award was procured by corruption, fraud, or undue means.
(b) Where there was evident partiality or corruption in the arbitrators, or either of them.
(c) Where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced.
(d) Where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.
(e) Where an award is vacated and the time within which the agreement required the award to be made has not expired the court may, in its discretion, direct a rehearing by the arbitrators.
9 U.S.C. § 10 (1964).

[24] 393 U.S. at 147.

[25] *Id.* at 148.

[26] 273 U.S. 510 (1927).

[27] 393 U.S. at 148.

[28] Section 18. Disclosure by Arbitrator of Disqualification—At the time of receiving his notice of appointment, the prospective Arbitrator is requested to disclose any circumstances likely to create a presumption of bias or which he believes might disqualify him as an impartial Arbitrator. Upon receipt of such information, the Tribunal Clerk shall immediately disclose it to the parties, who if willing to proceed under the circumstances disclosed, shall, in writing, so advise the Tribunal Clerk. If either party declines to waive the presumptive disqualification, the vacancy thus created shall be filled in accordance with the applicable provisions of this Rule.
Id. at 149, *quoting* AMERICAN ARBITRATION ASSOCIATION, COMMERCIAL ARBITRATION RULES § 18.

a canon of judicial ethics[29] providing for the avoidance of actions that might raise suspicions, neither of which were directly applicable to this controversy, were noted to show that these concepts of disclosure and of avoidance of suspicions were accepted elements of what is to be considered fair conduct on the part of those who perform adjudicatory functions.[30]

The concurring opinion by Mr. Justice White[31] declared that the Court's ruling did not hold arbitrators to the standards of judicial decorum required of judges, but only that disclosure was required "where the arbitrator has a substantial interest in a firm which has done more than trivial business with a party . . . ."[32] Mr. Justice Fortas' dissent[33] denied that the failure to volunteer information constituted "evident partiality" under the Arbitration Act where there was no claim of any actual partiality, or bias, or improper motive.[34]

In its successful efforts in the lower courts,[35] the respondent prime contractor relied on the case of *Ilios Shipping & Trading Corp. v. American Anthracite & Bituminous Coal Corp.*[36] for the proposition that "the mere fact that there is some business relationship between the arbitrator and one of the parties to the arbitration is not in and of itself sufficient to disqualify the arbitrator."[37] The court in *Ilios* reasoned that since the objecting party knew the arbitrator was employed in the insurance business, he should have inquired as to any relationship between the arbitrator and the other party.[38] Failing to do this, knowledge of the relationship will be imputed to the objecting party and he will be deemed to have waived his objection for failure to assert it earlier.[39] Thus, one basis of the holding in *Ilios* is the imputed knowledge the objecting party had of the relationship between the arbitrator

[29] 33 Social Relations.

> . . . [A judge] should, however, in pending or prospective litigation before him be particularly careful to avoid such actions as may reasonably tend to awaken the suspicion that his social or business relations or friendships constitute an element in influencing his judicial conduct.

Id. at 149-50, *quoting* ABA CANONS OF JUDICIAL ETHICS No. 33.

[30] *Id.* at 149-50.

[31] *Id.* at 150 (Mr. Justice Marshall joining).

[32] *Id.* at 151-52.

[33] *Id.* at 152 (Justices Harlan and Stewart joined in the dissent).

[34] *Id.* at 154.

[35] 382 F.2d 1010 (1st Cir. 1967).

[36] 148 F. Supp. 698 (S.D.N.Y.), *aff'd*, 245 F.2d 873 (2d Cir. 1957).

[37] *Id.* at 700.

[38] *Id.*

[39] *Id.*

and the other party. In *Commonwealth*, on the other hand, the Supreme Court emphasized that

> the facts concerning the close business connections between the third arbitrator and the prime contractor were unknown to petitioner and were never revealed to it by this arbitrator, by the prime contractor, or by anyone else until after an award had been made.[40]

While this may be one manner of distinguishing the *Ilios* case, there is considerable authority supporting the view that an arbitrator's failure to disclose past business relations with a party does not constitute "evident partiality" under the Arbitration Act.[41] At the same time, there are instances where the opposite view has prevailed—where the failure to disclose the relationship resulted in vacating the contested award.[42]

The differences in result would seem to hinge on fine distinctions in the fact situations. Should the possibility of the relationship have been apparent to the objecting party?[43] Was the relationship vague and remote,[44] or was it close enough to cause concern as to the arbitrator's impartiality?[45] Although finding in favor of respondent in *Commonwealth*, the court of appeals noted the closeness of the distinctions involved:

> In our opinion there is a difficult line between what should, in good faith, be volunteered, and what may be left for inquiry. We may agree with appellant that where there is a disturbingly close relationship the very failure to make disclosure could be evidence of partiality, and we think it would have been far better if there had been disclosure here. However, we cannot say that the relationship was sufficiently close to establish 'evident partiality' within the statute as a matter of law.[46]

Undoubtedly, the trend of the courts has been to set strict limits on judicial interference with arbitration awards.[47] Frequent court inter-

[40] 393 U.S. at 146. In a Petition for Rehearing filed January 16, 1969, the respondent contends "[t]here is not a scintilla of evidence to support" the Court's conclusion that "the facts concerning the close business connections between the third arbitrator and the prime contractor were unknown to petitioner . . . ." Respondent's Petition for Rehearing at 1.

[41] *See, e.g.*, Texas Eastern Transmission Corp. v. Barnard, 177 F. Supp. 123 (E.D. Ky. 1959), *rev'd on other grounds*, 285 F.2d 536 (6th Cir. 1960).

[42] *See, e.g.*, Rogers v. Schering Corp., 165 F. Supp. 295 (D.N.J. 1958), *aff'd*, 271 F.2d 266 (3d Cir.), *cert. denied*, 359 U.S. 991 (1959).

[43] *See* Ilios Shipping & Trading Corp. v. American Anthracite & Bituminous Coal Corp., 148 F. Supp. 698 (S.D.N.Y.), *aff'd*, 245 F.2d 873 (2d Cir. 1957).

[44] *See* Texas Eastern Transmission Corp. v. Barnard, 177 F. Supp. 123 (E.D. Ky. 1959), *rev'd on other grounds*, 285 F.2d 536 (6th Cir. 1960).

[45] *See* American Guar. Co. v. Caldwell, 72 F.2d 209 (9th Cir. 1934).

[46] 382 F.2d at 1011-12.

[47] *See, e.g.*, Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395 (1967).

ference might frustrate "the basic purpose of arbitration, which is to dispose of disputes quickly and avoid the expense and delay of extended court proceedings."[48] Although the action of the Court in *Commonwealth* in vacating the arbitration award and imposing a rule requiring disclosure on the arbitrator might at first glance appear to run counter to this ideal, a closer analysis indicates that the contrary is more likely. Certainly it was the aim of the Court, in formulating its rule requiring disclosure, to minimize the judicial role in arbitration. The rule formulated by the Court—that an arbitrator has a duty to disclose to the parties any dealings that might create an impression of possible bias—should strengthen the arbitration process and minimize judicial interference in at least two ways. First, requiring disclosure should give the parties additional faith in the fairness of the proceedings. Mr. Dooley advised: "Trust everybody—but cut the cards."[49] A duty of disclosure is an additional "cut of the cards" that should tend to lessen suspicions of a losing party that he was treated unfairly. With this additional confidence in the settlement process, the loser is less likely to take his complaint to the courts. Second, the rule requiring disclosure will provide an easily recognizable standard of conduct for the arbitrator. A hazy standard regarding impartiality might lead the losing party to attempt to obtain a favorable court interpretation. Judicial review of an arbitration award would appear to be sought less often where the demarcation between acceptable and unacceptable conduct is clear. Thus, the decision in *Commonwealth* should serve to strengthen the participants' confidence in arbitration, and should decrease further the possibility of unnecessary judicial interference in the arbitration process.

JOHN M. MURCHISON, JR.

Civil Procedure—Attachment of Liability Insurance Policies

The plaintiff, a New York resident, is injured in an automobile accident in another state. The wrongdoer, who is not subject to personal jurisdiction in New York, is insured under a liability policy issued in the state of his residence by an insurance company that does business in New

See generally, Jalet, *Judicial Review of Arbitration: The Judicial Attitude,* 45 CORNELL L.Q. 519 (1960); Comment, *Commercial Arbitration: Expanding the Judicial Role,* 52 MINN. L. REV. 1218 (1968).

[48] Saxis Steamship Co. v. Multifacs Int'l Traders, Inc., 375 F.2d 577, 582 (2d Cir. 1967).

[49] F. DUNNE, MR. DOOLEY'S PHILOSOPHY (1900).

York. Plaintiff brings his suit in New York against the insurer,[1] and contends that the insurance policy obligations constitute an attachable res in a quasi in rem proceeding.[2]

Confronted with these facts, the New York Court of Appeals in *Seider v. Roth*[3] held that an automobile insurance policy issued by an out-of-state insurer that does business in New York was an attachable debt within the statutory definition of "debt."[4] The debt subject to attachment was found to be the obligation of the insurance company to defend and indemnify the assured upon the occurrence of an accident.[5] This novel theory of quasi in rem jurisdiction, which has caused both uncertainty and speculation among commentators,[6] was followed recently by the District Court

[1] It would not matter that suit was brought in a federal forum, for as stated in Arrowsmith v. UPI, 320 F.2d 219 (2d Cir. 1963), "the amenability of a foreign corporation to suit in a federal court in a diversity action is determined in accordance with the law of the state where the court sits. . . ." *Id.* at 223.

[2] For a discussion of quasi in rem jurisdiction, see H. WACHTELL, NEW YORK PRACTICE UNDER THE CPLR 15-16 (2d ed. 1966). The author states:

> [I]f any property belonging to the defendant is within the state, such property may be seized (levied upon) pursuant to an order of attachment, and the property so levied upon is then deemed to constitute a "res" within the state, permitting the court to adjudicate whether the debt claimed by plaintiff should be satisfied out of the attached property.

Id.

[3] 17 N.Y.2d 111, 216 N.E.2d 312, 269 N.Y.S.2d 99 (1966).

[4] See N.Y. CIV. PRAC. LAW §§ 5201, 6202 (McKinney 1963). Section 5201 provides:

> (a) Debt against which a money judgment may be enforced. A money judgment may be enforced against any debt, which is past due or which is yet to become due, certainly or upon demand of the judgment debtor, whether it was incurred within or without the state, to or from a resident or non-resident, unless it is exempt from application to the satisfaction of the judgment. A debt may consist of a cause of action which could be assigned or transferred accruing within or without the state.
>
> (b) Property against which a money judgment may be enforced. A money judgment may be enforced against any property which could be assigned or transferred, whether it consists of a present or future right or interest and whether or not it is vested, unless it is exempt from application to the satisfaction of the judgment.

Id. § 5201. Section 6202 provides that debts described in section 5201 are subject to attachment. *Id.* § 6202.

[5] 17 N.Y.2d at 114, 216 N.E.2d at 315, 269 N.Y.S.2d at 102.

[6] *See* Note, *Attachment of Liability Insurance Policies*, 53 CORNELL L. REV. 1108 (1968); Note, *Foreign Attachment: Attaching Liability Insurance Contract Rights as a Means of Securing Jurisdiction of Non-Resident Defendant*, 10 S. TEX. L.J. 59 (1968); Note, *Civil Procedure—The Insurance Policy of a Non-Resident Insured May Be Subject to Attachment in New York*, 18 SYRACUSE L. REV. 631 (1967); Note, *Jurisdiction—Attachment of Automobile Liability Insurance—Insurer's Obligation Is Attachable if He Does Business Within the State*, 35 U. CIN. L. REV. 691 (1966).

for the Southern District of New York in *Barker v. Smith.*[7]

In *Barker*, the insurance contract was written and the accident subsequently occurred in Michigan. The corporate offices of both the insurer and the insured were also located in Michigan. Since Michigan had previously neither permitted the attachment procedure sanctioned in *Seider* nor authorized a direct action against the insurer,[8] the New York rather than the Michigan attachment procedure had to be applied to obtain quasi in rem jurisdiction. The court in *Barker* found that the expenses and pain suffered by the plaintiff in New York coupled with the fact that the insurer was doing business in New York constituted sufficient "activities relating to the contract"[9] to apply the New York rule treating the policy obligations as an attachable debt.[10]

Prior to *Seider*, attachment of an insurer's obligations would not have been possible primarily because the interpretation given to the statutory definition of an attachable debt in New York did not include these obligations. Thus, a necessary prerequisite for in rem or quasi in rem jurisdiction—the presence of an attachable res within the state[11]—had been absent. Then, in *Seider*, the insurer's obligation to defend and indemnify the insured was held to be the attachable res. This reasoning appears to be consistent with the rule of *Harris v. Balk*[12] that the situs of a debt follows the debtor and is subject to garnishment wherever the debtor is found. That case emphasized, however, that it was dealing with a simple debt,[13] which can only be in one place at one time.[14] But if the insurance company's "debt" is found to be in New York because the insurance company is doing business in New York, the debt also exists in every other jurisdiction in which the insurer is doing business. Moreover, the general rule is that an obligation subject to a condition precedent is not attachable.[15] Yet the courts in *Seider* and later in *Barker*, finding that certain obligations of the insurance company accrue as soon as it

[7] 290 F. Supp. 709 (S.D.N.Y. 1968).

[8] Louisiana and Wisconsin consider the insurer to be the real party in interest and allow a plaintiff to sue the defendant's insurance company directly. *See* LA. REV. STAT. § 22:655 (Supp. 1968); WIS. STAT. § 260.11(1) (1965).

[9] 290 F. Supp. at 713.

[10] *Id.*

[11] *See* Harris v. Balk, 198 U.S. 215, 222 (1905); Pennoyer v. Neff, 95 U.S. 714, 722-23 (1878). There must also be effective seizure and adequate notice to the owner to establish quasi in rem jurisdiction.

[12] 198 U.S. 215 (1905).

[13] *Id.* at 222.

[14] *See* Podolsky v. Devinney, 281 F. Supp. 488 (S.D.N.Y. 1968).

[15] *See, e.g.*, 38 C.J.S. *Garnishment* § 87 (1943).

receives notice of an accident,[16] held that the entire face amount of the policy, including the insurer's contingent obligation to indemnify, was garnishable, and thus expanded the definition of "debt" to include obligations subject to a condition precedent.

A secondary conflict-of-laws problem was encountered in the fact situations of *Seider* and *Barker*. Since an insurance policy is not an attachable debt in Michigan, New York had to apply its laws interpreting the contract to find an attachable res. Initially, the situs of the contract[17] was the only relevant constitutional consideration under the territorially oriented vested-rights theory. The Supreme Court later modified this rule when it decided that a state with a "legitimate interest"[18] in the application of its law may apply it without overstepping constitutional limitations, although it remains unclear exactly what minimum contacts are sufficient to result in such an interest. Although *Seider* disregarded the problem of minimum contacts, the court in *Barker* established two prerequisites necessary before a state can constitutionally define the contract obligations under a liability insurance policy written beyond its borders without interfering with the sovereignty of sister states.[19] First, a state must have a legitimate interest in the application of its laws, and in *Barker* the court found that the interest of New York in preventing its citizens from becoming public charges satisfied this requirement.[20] Second, activities must have occurred within the state that are "neither too slight nor too casual to make application of its law inconsistent with due process."[21] The expenses and suffering of the plaintiff and the insurer's doing business in New York were held sufficient to satisfy this requirement.[22]

The attachment procedure sanctioned by *Seider* seems to contain "few

[16] Typical obligations accruing as soon as the insurer receives notice of the accident are obligations to investigate and to defend. *See* Podolsky v. Devinney, 281 F. Supp. 488, 494 (S.D.N.Y. 1968).

[17] RESTATEMENT OF CONFLICTS OF LAWS § 332 (1934). Interpreting the contract solely by the law of the jurisdiction in which it was consumated emphasized the importance of the situs in which the vested contract right arose. *See* Note, *Direct-Action Statutes: Their Operational and Conflict-of-Law Problems,* 74 HARV. L. REV. 357, 387-92 (1960).

[18] Watson v. Employers Liab. Assur. Corp., 387 U.S. 66, 73 (1954). For a recent New York application of conflict of laws theory, see Miller v. Miller, 22 N.Y.2d 12, 237 N.E.2d 877, 290 N.Y.S.2d 734 (1968), *reviewed in* Note, *Conflict of Laws—Choice-of-Laws: The Greatest Interest Rule,* 47 N.C.L. REV. 407 (1969).

[19] 290 F. Supp. at 712.

[20] *Id. See* Simpson v. Loehmann, 21 N.Y.2d 305, 313, 234 N.E.2d 669, 673, 287 N.Y.S.2d 633, 639 (1967).

[21] 290 F. Supp. at 713.

[22] *Id.*

if any limiting conditions on the bringing of an action in New York. It appears that the plaintiff need not even be a resident of New York."[23] The emphasis that *Barker* placed on the plaintiff's suffering and medical expenses in New York, however, may imply that mere domicile of the plaintiff and business contacts of the insurer in the attaching state are insufficient contact.[24] If this implication becomes the rule, the attachment of insurance obligations as in *Seider* would be limited to some extent.[25]

Neither *Seider* nor *Barker* attempted to resolve whether attachment of an insurance obligation comports with due process requirements of the fourteenth amendment. The district court in *Podolsky v. Devinney*[26] found that garnishment of insurance policies was violative of due process because New York did not permit the insured to make a personal appearance and defend on the merits without subjecting himself to in personam jurisdiction and to the possibility of a judgment greater than the policy limits.[27] Also found objectionable was that in the event of the insured's default, "there is no way that the insurance company can appear to litigate its interests."[28] In response to this decision, the New York Court of Appeals in *Simpson v. Loehmann*[29] held that if the insured were required to defend, in personam jurisdiction would not be extended beyond the limits of the policy. The risk remains, however, that the insured might refuse assistance to the insurer.

The problems arising out of the insurer's inability to defend either its or the insured's interests result from applying the rules applicable to the garnishment of simple debts to the attachment of insurance obligations. Generally, the garnishee is considered as having no interest in the res and therefore may not "set up matters which affect the defendant only."[30]

[23] Podolsky v. Devinney, 281 F. Supp. 488, 498 n.25 (S.D.N.Y. 1968).

[24] The Supreme Court, in Alaska Packers Ass'n v. Industrial Acc. Comm'n, 294 U.S. 532 (1935), indicated that a plaintiff's domicile might have a constitutionally supportable interest, but this case, unlike *Seider* and *Barker*, involved a plaintiff who would otherwise have been remediless. Louisiana and Wisconsin, which allow direct actions against insurers, do not permit suits when the accident occurred outside of their state, possibly implying sufficient contact only when the accident occurred within its borders. *See* LA. REV. STAT. § 22:655 (Supp. 1952); WIS. STAT. § 260.11(1) (1963).

[25] In a very recent case, the second circuit also implied that *Seider* may not be validly applied where the state was neither the place of injury nor the plaintiff's residence. Minichiello v. Rosenberg, — F.2d — (2d Cir. 1968).

[26] 281 F. Supp. 488 (S.D.N.Y. 1968).

[27] *Id.* at 489.

[28] *Id.* at 499.

[29] 21 N.Y.2d 990, 238 N.E.2d 319, 290 N.Y.S.2d 914 (1968).

[30] 38 C.J.S. *Garnishment* § 196, at 432 (1943).

In the application of its garnishment law, New York has held that if the insured "chooses not to appear, any unauthorized appearance on his behalf by attorneys retained by the insurance company would be a nullity as against him."[31] The difficulties are apparent in analogizing an insurance policy to a simple debt, for "the obligation to defend an insured is not to be regarded simply as a duty owed to the holder of the policy but also as an essential right which the insurance company reserves to itself in order to protect itself against unwarranted liability claims."[32] This problem has not been directly confronted by the New York Court of Appeals, but dictum in *Simpson v. Loehmann*[33] would allow the insurer to use an insured's failure to comply with the terms of the policy as a defense. It is not certain, however, that New York will follow this position.[34] Regardless of whether the defense of non-cooperation is allowed, if New York prohibits the insurer from asserting the insured's defenses, there are obvious opportunities for collusion. Possible collusion between the insurer and the insured exists if a defense of non-cooperation is permitted; collusion opportunities between the insured and the plaintiff arise if such defense is disallowed. In contrast, in a direct action the company can "contest the assured's liability and raise its policy defenses since here it does not have the option of withdrawing from the case without a complete default on the merits."[35]

There will be additional problems if other jurisdictions adopt similar attachment procedures. For example, if an accident occurred involving plaintiffs who were citizens of New York and of another jurisdiction that allowed such attachment, and the defendant's insurer was doing business in both jurisdictions, would the debt be situated in both states at the same time?[36] A related problem arises when attachment is levied in New

[31] Podolsky v. Devinney, 281 F. Supp. 488, 499 (S.D.N.Y. 1968). *See also* Earl S. Peed Organ., Inc. v. Gray, 40 Misc. 2d 471, 473, 243 N.Y.S.2d 111, 113 (Sup. Ct. 1963). These cases were decided on the basis of N.Y. INS. LAW § 167 (McKinney 1966).

[32] Podolsky v. Devinney, 281 F. Supp. 488, 499 (S.D.N.Y. 1968).

[33] 21 N.Y.2d at 309 n.2, 234 N.E.2d at 670 n.2, 287 N.Y.S.2d at 635 n.2. See also Siegel, *Simpson Upholds Seider—Problems for Both Sides, Notes and Views,* N.Y.L.J., Jan. 24, 1968, at —.

[34] Louisiana and Massachusetts do not permit the defense of non-cooperation. *See, e.g.,* West v. Monroe Bakery, 217 La. 190, 46 So. 2d 122 (1950); MASS. ANN. LAWS ch. 175, § 113A(5) (1959).

[35] Note, *Direct-Action Statutes: Their Operational and Conflict-of-Law Problems,* 74 HARV. L. REV. 357, 366 (1960).

[36] See Note, *Jurisdiction—Attachment of Automobile Liability Insurance—Insurer's Obligation Is Attachable if He Does Business Within the State,* 35 U. CIN. L. REV. 691 (1966).

York by one of two plaintiffs injured simultaneously in a foreign jurisdiction and the other plaintiff has obtained an in personam judgment against the defendant and seeks execution out of the attached insurance policy.[37]

New York is the first jurisdiction in which the highest state court has "enacted" the equivalent of a direct action statute.[38] By an extremely broad definition of a simple debt, an expanded conflicts test, an extended jurisdiction test, and a novel use of the garnishment process, New York has protected its residents under the guise of a quasi in rem proceeding. Admittedly, the state of the plaintiff's residence has a definite interest in protecting its citizens. *Barker*, however, dismisses the interests of the insurer and the insured by recommending that "inconvenience or hardship . . . may be alleviated by way of a motion for a change of venue."[39] This statement is based on the assumption that the parties will be able to obtain federal jurisdiction or that the forum will allow a change in venue.[40] Even though *Barker* allowed the attachment of the insurance obligation, there is no necessary implication that all attachments possible under *Seider* are valid. The basic issue remains a determination of whether there are sufficient interests and contacts in New York to sustain jurisdiction over a corporation's intangible obligations on a cause of action arising out of state.[41] It has been suggested that the insurance contract

[37] *See* Note, *Civil Procedure—The Insurance Policy of a Non-Resident Insured May Be Subject to Attachment in New York*, 18 SYRACUSE L. REV. 631 (1967).

[38] *See* Podolsky v. Devinney, 281 F. Supp. 488 (S.D.N.Y. 1968); Note, *Jurisdiction—Quasi-in-Rem—Insurance—Attachment of Automobile Liability—Insurer's Obligations to Defend and Indemnify*, 8 B.C. IND. & COM. L. REV. 147 (1966); Comment, *Garnishment of Intangibles: Contingent Obligations and the Interstate Corporation*, 67 COLUM. L. REV. 550 (1967).

[39] 290 F. Supp. at 714. The court here employed the approach of Watson v. Employers Liab. Assur. Corp., 348 U.S. 66 (1954), which held that when "a contract affects the people of several states, each may have interests that leave it free to enforce its own contract policies." *Id.* at 73. In Alaska Packers Ass'n v. Industrial Acc. Comm'n, 294 U.S. 532 (1935), the Court stated that a party who challenges a court's choice of laws "assumes the burden of showing, upon some rational basis, that of the conflicting interests involved those of the foreign state are superior to those of the forum." *Id.* at 547-48. While *Watson* may allow a state to apply its law if it has sufficient contact regardless of the other state's interests, *Alaska Packers* seems to imply a balancing of competing interests.

[40] The insurer may be unable to obtain federal jurisdiction for diversity or jurisdictional amount reasons and the jurisdiction in which the suit is brought may not recognize the doctrine of forum non conveniens. *See* 28 U.S.C. § 1332 (1964).

[41] *See, e.g.*, Comment, *Attachment of "Obligations"—A New Chapter in Long Arm Jurisdiction*, 16 BUFFALO L. REV. 769 (1967); Comment, *Garnishment of Intangibles: Contingent Obligations and the Interstate Corporation*, 67 COLUM. L.

should be regarded merely as another contact and not the sole determinant of jurisdiciton over an out-of-state cause of action.[42] Perhaps a legislative solution to this problem might resolve the present uncertain status of New York attachment law.[43]

GEORGE HACKNEY EATMAN

Civil Procedure—Serving Statement of Case on Appeal in North Carolina—An Unfortunate Interpretation

In North Carolina two formal steps are required in appealing a decision from a trial court. The appellant must prepare and serve to the appellee a statement of the case on appeal, and the case must be docketed on the appellate court's calendar in accordance with the rules of the higher court.

N.C. GEN. STAT. § 1-282[1] allows only fifteen days to serve statement of case on appeal and ten days thereafter for counter case or exception, but the statute includes a proviso that gives the trial judge discretion "to enlarge the time in which to serve statement of case on appeal and exceptions thereto or counter statement of case."[2] The statute does not expressly authorize any subsequent extensions of time to be ordered by the judge hearing the case. As a practical matter, however, it is sometimes impossible for the appellant to secure a copy of the transcript of the trial and to prepare his statement within the original extension period set by the judge. Often the delay is occasioned by an official of the court, but the North Carolina Supreme Court has ruled that this does not excuse a failure to serve the statement within the time allotted.[3] Consequently, it has been common practice for the trial judge, even without specific statu-

REV. 550 (1967); Note, *Quasi In Rem Jurisdiciton Based on Insurer's Obligations*, 19 STANFORD L. REV. 654 (1967).

[42] *See, e.g.*, Comment, *Garnishment of Intangibles: Contingent Obligations and the Interstate Corporation*, 67 COLUM. L. REV. 550, 567-71 (1967).

[43] Such a statute should at least do the following: (1) allow the insurer to set up the defenses of the insured, (2) resolve whether the insurer can defeat an action successfully on the insured's failure of cooperation, and (3) clearly specify the minimum contacts in New York sufficient to attain jurisdiction.

[1] N.C. GEN. STAT. § 1-282 (1953).

[2] *Id.*

[3] State v. Wescott, 220 N.C. 439, 17 S.E.2d 507 (1941) (illness of the court reporter); Rogers v. City of Asheville, 182 N.C. 596, 109 S.E. 685 (1921) (stenographer busy).

tory authority, to grant a second and even a third extension for service of the case upon request by the appellant.

Most appeals are now taken to the new intermediate appellate court.[4] Rule 5 of the North Carolina Court of Appeals provides that the case on appeal must be docketed within ninety days after judgment.[5] Yet, the trial judge is authorized to extend the time for up to an additional sixty days for good cause shown. Construing § 1-282 and Rule 5 together, the reasonable and practical construction would be that since the trial judge can extend the time for both serving and docketing the case on appeal and since there is no express limitation on his granting successive extensions for service or docketing, he has the authority to grant successive extensions of time for service and docketing. The only implicit limitation would be that the extensions of time for service of case on appeal cannot exceed the one hundred and fifty day limit for docketing imposed by Rule 5.[6]

Interpreting the statute narrowly, the North Carolina Court of Appeals held in *Roberts v. Stewart*[7] that additional extensions of time granted by the trial judge for service of the case on appeal were entered without authority because upon filing the notice of appeal the case was removed to the court of appeals.[8] Since there was no case on appeal before the court, the court reviewed only the record proper for error, and finding none, affirmed the decision of the superior court.

As authority for its decision, the court in *Roberts* relied principally upon *American Floor Machine Co. v. Dixon*.[9] There the supreme court, in interpreting the statute creating a county civil court,[10] held that upon filing notice of appeal from the county court to the superior court the case was removed to the higher court, thereby making the trial judge *functus officio*.[11] The judge thus no longer had jurisdiction to extend the time for service of case on appeal beyond his original order setting the time

[4] See Steed, *The North Carolina Court of Appeals—An Outline of Appellate Procedure*, 46 N.C.L. REV. 705 (1968).

[5] N.C. CT. APP. R. 5 (the rules may be found in the 1967 supplement to Volume 4A of N.C. GEN. STAT.).

[6] In granting extensions of time for service, the trial judge must allow sufficient time to settle the statement of the case if the appellee files exceptions, so that docketing may still take place under Rule 5.

[7] 3 N.C. App. 120, — S.E.2d — (1968).

[8] *Id.* at 124, — S.E.2d at — (1968).

[9] 260 N.C. 732, 133 S.E.2d 659 (1963); *accord*, Pelaez v. Carland, 268 N.C. 192, 150 S.E.2d 201 (1966).

[10] Ch. 691, § 59, [1937] N.C. SESS. LAWS (repealed 1967) (this statute providing for the establishment of county civil courts was repealed in 1967 when the statutes setting up the new district court system became effective).

[11] 260 N.C. at 735-36, 133 S.E.2d at 662.

for service.[12] His only remaining authority was to resolve the statements of case on appeal, if the appellee filed a counter statement or exceptions that gave a different account of the events at trial, or to adjudge an abandonment of the appeal.[13]

It is arguable that the court reached a correct result in *Roberts* since the supreme court's ruling in *American Floor Machine Co.* was rendered in 1963 and the profession and bench should have been aware of the opinion. Yet, the court was not interpreting § 1-282 in *American Floor Machine Co.*, even though the situations were analogous in that both involved an appeal to a higher court. Moreover, to apply the familiar fiction that an attorney and judge are deemed to "know the law" seems unnecessary and even unfair in this circumstance where practicality should be a paramount consideration and where a contrary result could have rested upon a more reasonable interpretation of the purposes of the statute and court rule.

The fact that the court of appeals heard three other cases in 1968 dealing with extensions of time for service should testify to the frequency of the practice. In the first case, *Smith v. Stevens*,[14] the court chose not to dismiss the appeal *ex mero motu*, the appellee not having moved to dismiss. The court considered the appeal on the merits and granted a new trial, although the trial judge had granted subsequent extensions to serve the statement of case on appeal under color of Rule 5, but had not extended the time for docketing the case. Another case, *Williams v. Williams*,[15] was dismissed under Rule 16[16] because the statement was served one hundred and fifty-three days after judgment was entered. In *State v. Farrell*,[17] decided after *Roberts*, the appellant had been granted successive extensions of time totalling one hundred and twenty days to serve the case. The court said the appeal should be dismissed. The court reviewed the record, however, "to determine that justice is done," and found no prejudicial error,[18] even though, unlike *Roberts*, no order was entered extending the time for docketing, which took place one hundred and fifty days after the judgment. In a parenthesis in the opinion, the court said:

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[12] *Id.*

[13] *Id.*

[14] 1 N.C. App. 192, 160 S.E.2d 547 (1968).

[15] 1 N.C. App. 446, 161 S.E.2d 757 (1968).

[16] Rule 16 provides for a motion, before argument on the merits of the case, to dismiss the appeal for failure to comply with the requirements of statutes or rules of the court in perfecting an appeal.

[17] 3 N.C. App. 196, — S.E.2d — (1968).

[18] *Id.* at 200, — S.E.2d at —.

> Each of these extensions of time was consented to by the Solicitor and upon this record we make no decision whether the trial judge has authority under G.S. 1-282, with or without the consent of the parties, to extend the time for serving case on appeal beyond that contained in the original order extending the statutory time.[19]

This statement could indicate that the court itself did not "know the law" it had so recently set forth. On the other hand, the court may have thought that this issue was not ripe for consideration because no extension had been granted for docketing.

The technicality in appellate procedure raised by the court's decision in *Roberts* was rectified in early 1969 by newly adopted Rule 50.

> If it appears that the case on appeal cannot be served within the time provided by statute, rule, or order, the trial judge (or the chairman of the Industrial Commission or the chairman of the Utilities Commission as the case may be) may, for good cause and after notice to the opposing party or counsel, enter an order or successive orders extending the time for service of the case on appeal and counter-case or exceptions to the case on appeal, provided this does not alter the provisions of Rule 5 relating to the docketing of the case on appeal.[20]

It is interesting to note that the North Carolina Supreme Court in effect overruled the decision in *Roberts* by adoption of a court rule rather than by judicial decision.

It is arguable that § 1-282 pre-empts the field of service of the case, thereby making the supreme court's promulgation of Rule 50 technically improper.[21] Service of the case, however, seems to be a procedural requirement for appeal and the supreme court has exclusive authority under the constitution[22] and by statute[23] to provide rules of practice and procedure for the appellate division. Thus, if Rule 50 is interpreted to be in conflict with § 1-282, the statute would seem to be invalid because the legislature cannot change a rule of the court.[24] Yet, Rule 50 may be seen as nothing

[19] *Id.* at 198-99, — S.E.2d at —.

[20] N.C. CT. APP. R. 50 (since this new rule was only adopted Feb. 11, 1969, as of this writing it may only be found in advance sheet No. 3 to 3 N.C. App. at xv).

[21] *See* Lehnen v. Hines & Co., 88 Kan. 58, 127 P. 612 (1912) (dictum) (court may enforce reasonable rules regulating practice in pending cases, but times set by statute within which steps are to be taken cannot be shortened by rules).

[22] N.C. CONST. art. IV, § 11.

[23] N.C. GEN. STAT. § 7A-33 (Supp. 1967).

[24] State v. Martin, 210 N.C. 459, 187 S.E. 586 (1936); Calvert v. Carstarphen, 133 N.C. 25, 45 S.E. 353 (1903); *accord*, Jaworski v. City of Opa-Locka, 149 So. 2d 33 (Fla. 1963).

more than a clarification of the meaning of § 1-282,[25] in which case Rule 50 would not be an implicit declaration by the supreme court that § 1-282 is invalid as an infringement on the court's right to promulgate procedural rules for the appellate division.

As a word of warning to the practicing bar, it should be emphasized that Rule 5 itself does not specifically authorize the trial court to enter *successive* orders extending the time for docketing the case on appeal. Possibly, then, a trial judge may have jurisdiction to issue only one order extending the time for docketing the appeal. Thus, it may become necessary for the supreme court to adopt a docketing rule, similar to Rule 50, authorizing the trial judge to grant *successive* extensions of time for docketing the appeal within the one hundred and fifty day limit of Rule 5. Hopefully, in making future rulings on appellate procedure, the new intermediate court will be less narrow in its view of the processes of appeal and will accommodate its interpretation of the rules to the practicalities involved.

ROBERT A. WICKER

Contracts—Contracts To Devise—Effect of Excluded Forced Heirs

A contract to make a will necessarily juxtaposes the law of contracts and of decedent's estates and brings into conflict the policy of compelling performance of a promise with that of allowing free testamentary disposition.[1] A recent case, *In re Estate of Stewart*,[2] injected a third basic consideration: the effect of an excluded forced heir upon the distribution of property willed pursuant to an antenuptial contract to devise. The California Supreme Court held the contract beneficiaries' interest paramount to the forced heir's claim, thus upholding the policy for contractual certainty of performance against the challenge posed by the conflicting policy disfavoring spousal disinheritance. The court's treatment of the problem brings the factors involved sharply into focus.

In 1936, Walter Stewart, his wife Jennie, and his brother John, cotenants of specific real property, entered into a written contract to devise

[25] See text accompanying notes 5 & 6, *supra*.

[1] Note, *Separation Agreements to Make Mutual Wills for the Benefit of Third Parties*, 18 HASTINGS L.J. 423 (1967); *see generally*, 6 R. POWELL, REAL PROPERTY § 963 (1965).

[2] — Cal. 2d —, 444 P.2d 337, 70 Cal. Rptr. 545 (1968).

their respective one-third interests in the property to the survivors for life and to their respective children on the death of the last survivor.[3] Each made a will pursuant to the contract.[4] Upon John's death in 1947, Walter and Jennie held as cotenants for life, with Walter, due to a lapse in John's will, taking the remainder in John's one-third interest in fee.[5] When Jennie died in 1949, Walter took her interest in the property for life, and became vested with John's interest in fee simple. Walter subsequently remarried. When he died in 1965, his survivors included his widow, a brother, and six stepchildren (Jennie's children by a previous marriage). His estate consisted of the one-third interest in the realty he owned in 1936 plus the one-third interest he inherited from his brother John.[6] The widow was appointed administratrix, and the decedent's 1936 will was admitted to probate. As administratrix, the widow petitioned for a decree determining interests in the decedent's estate.

The trial court found that, as a California statute[7] revoked the will as to the pretermitted spouse, Walter's widow took one-half of the estate,[8] with the remaining one-half passing under the will to the stepchildren.[9] The court of appeals[10] determined that the contract was made

[3] *Id.* at —, 444 P.2d at 338, 70 Cal. Rptr. at 546.

[4] *Id.* Walter left his interest to Jennie and John, or the survivor, remainder in equal shares to his daughter, who predeceased him, and his six stepchildren.

[5] *In re* Estate of Stewart, 63 Cal. Rptr. 548 n.1 (Dist. Ct. App. 1968). Walter and another brother, Sankey, were John's heirs, but for reasons undisclosed in the record, Sankey did not share in the property. Hence Walter had a life estate in cotenancy by virtue of John's will with a remainder in fee by intestate succession, which, upon Jennie's subsequent death extinguishing the intervening life estate in cotenancy, merged into a fee (the court's language is imprecise here).

[6] The remainder of Jennie's one-third interest passed to her six children (Walter's stepchildren) under her will when Walter died, and was not included as part of Walter's probate estate.

[7] CAL. PROB. CODE § 70 (West 1956). It provides that

> [i]f a person marries after making a will, and the spouse survives the maker, the will is revoked as to the spouse, unless provision has been made for the spouse by marriage contract, or unless the spouse is provided for in the will, or in such a way mentioned therein as to show an intention not to make such provision . . . .

CAL. PROB. CODE § 23 (West 1956) provides that a mutual will may be revoked "in like manner as any other will."

[8] CAL. PROB. CODE § 223 (West 1956) provides:

> If the decedent leaves a surviving spouse and no issue, the estate goes one-half to the surviving spouse and one-half to the decedent's parents in equal shares, or if either is dead to the survivor, or if both are dead to their issue and the issue of either of them, by right of representation.

[9] Two supreme court justices would have affirmed the trial court's decision. — Cal. 2d at —, 444 P.2d at 340, 70 Cal. Rptr. at 548.

[10] *In re* Estate of Stewart, 63 Cal. Rptr. 548 (Dist. Ct. App. 1968).

"expressly for the benefit" of the stepchildren as required by Civil Code § 1559,[11] and reasoned that the decedent could not have effectively willed the property to anyone except them,[12] thus reversing the trial court. The California Supreme Court, however, vacated the decision of the court of appeals,[13] and held that the widow was entitled only to half of that half of the estate that the decedent had inherited from his brother John.

Although the decedent's post-testamentary marriage resulted in partial revocation of the will, the supreme court stated that such revocation "does not impair the stepchildren's right to enforcement of the contract, for such a partial revocation can no more prejudice their rights than could a total revocation in repudiation of the contract."[14] The court reasoned that since the decedent had received the benefits of the contract, he "became estopped from making any other or different disposition of the property . . . ," nor could he "avoid this estoppel . . . by a subsequent marriage. . . ."[15] As the property belonged in equity to the stepchildren the widow's right could attach only to property both legally and equitably owned by the decedent, which was the one-third interest he had inherited from his brother John. This half of that interest, the court concluded, is all she would have taken had the decedent died intestate; to give her more when the decedent performed his contract than she would have received had he breached it "would be anomalous."[16]

Numerous courts in other jurisdictions have been confronted with the problems involved in contracts to make mutual wills and have resolved them upon widely disparate principles. That contracts to make wills are valid and enforceable[17] both in law[18] and in equity[19] seems well-

[11] CAL. CIV. CODE § 1559 (West 1954) secures third-party beneficiary rights. See note 32 *infra*. The court of appeals cited with approval Brewer v. Simpson, 53 Cal. 2d 265, 349 P.2d 289, 2 Cal. Rptr. 609 (1958), where remaindermen after a similarly-created life estate were allowed to enjoin alienation by the life tenant.

[12] The court of appeals relied on Allen v. Payson, 170 Misc. 759, 11 N.Y.S.2d 28 (Sup. Ct. 1939). There, in construing a statute similar to CAL. PROB. CODE § 70 (West 1956), the court held that the statute did not affect enforceable contracts, whether those seeking enforcement were creditors or *cestui que* trusts. *But see* note 58 *infra*, and accompanying text.

[13] — Cal. 2d —, 444 P.2d 337, 70 Cal. Rptr. 545 (1968).

[14] *Id.* at —, 444 P.2d at 339, 70 Cal. Rptr. at 547.

[15] *Id.*, *quoting* Sonnicksen v. Sonnicksen, 45 Cal. App. 2d 46, 55, 113 P.2d 495, 500 (Dist. Ct. App. 1941).

[16] — Cal. 2d at —, 444 P.2d at 340, 70 Cal. Rptr. at 548.

[17] 1 W. PAGE, WILLS § 10.1, at 432 (1960).

[18] *E.g.*, Morrison v. Land, 169 Cal. 580, 584, 147 P. 259, 263 (1915).

[19] *E.g.*, Baylor v. Bath, 189 S.C. 269, 1 S.E.2d 139 (1938).

settled. But the time such contracts become enforceable and the extent and manner in which they can be enforced are not so clear.

Generally, bilateral contracts are enforceable from the time a promise is given in exchange and as consideration for another promise.[20] Contracts to make mutual wills, however, do not seem to be treated in accordance with the rules governing ordinary bilateral contracts. Some cases state that parties may repudiate without liability for breach of contract while both are still living;[21] indeed, this has been said to be the general rule.[22] According to this view, the contract becomes binding when, as in *Stewart*, one party dies with a will pursuant to the contract in effect.[23] If the survivor probates such a will and receives its benefits, the surviving party is held estopped from repudiating his contract.[24]

The reason usually advanced to support the application of these principles is that the privilege of free testamentary disposition should not be subject to the usual rules of contract law. Enforceability of a contract as of the time of creation might shackle the essentially ambulatory and revocable attributes of wills. "Certainly, some freedom to change one's mind is necessary for free intercourse between those who lack omniscience."[25] Conseqeuently, contract law attempts to balance between this freedom to change one's mind and the interests of others that merit protection.[26] Such flexible principles of equity as mutual assent, consideration, and fraud were developed to avoid undue harshness resulting from compelling performance of a promise.[27] Since future actions are

[20] RESTATEMENT OF CONTRACTS §§ 74, 77 (1932).

[21] [W]hile both or all of the parties to such an agreement are yet alive, any party may recede therefrom, and revoke his will or make a different disposition . . . on giving proper notice . . . or where such other or others have actual knowledge . . . provided such other is afforded an ample opportunity to make a new will, and has not changed his position, to his detriment, in reliance on the agreement.

97 C.J.S. *Wills* § 1367, at 306-07 (1957). As indicated, most courts require notice of the revocation. *E.g.*, Frazier v. Patterson, 243 Ill. 80, 90 N.E. 216 (1909). For a thorough analysis of this proposition, see Sparks, *Legal Effect of Contracts To Devise or Bequeath Prior To the Death of the Promisor* (pt. II), 53 MICH. L. REV. 215, 222-31 (1954).

[22] Allen v. Dillard, 15 Wash. 2d 35, 52, 129 P.2d 813, 820 (1942).

[23] *But see* Schramm v. Burkhart, 137 Ore. 208, 2 P.2d 148 (1931), which suggests that the contract is binding when the mutual wills are executed.

[24] *E.g.*, Brown v. Superior Ct., 34 Cal. 2d 559, 212 P.2d 878 (1949). In some jurisdictions the contract may not be binding until that time. *See* Tooker v. Vreeland, 92 N.J. Eq. 346, 112 A. 665 (Ch. 1921).

[25] Cohen, *The Basis of Contract*, 46 HARV. L. REV. 553, 573 (1933).

[26] *See* 1 A. CORBIN, CONTRACTS § 1 (1963).

[27] "The proposition that an agreement to make mutual wills is unenforceable without estoppel, is perhaps the result of a latent dislike for the rule . . . that a

naturally subject to change, as is a will, the *power* to break a contract always exists; it is the *right* to do so without incurring liability that contract law seeks to determine. This determination is guided by principles sufficiently flexible to derive just results. The application of the estoppel doctrine in the *Stewart* context seems an unnecessary importation; the contract should be enforced, if at all, on contract principles.[28] While in *Stewart* the result is the same under either analysis, in cases of a breached contract to make a will, the conclusion reached can vary with the theory applied. The use of the estoppel doctrine rather than normal contract rules to implement enforcement seems a deviation from sound jurisprudence, the principal result of which is confusion.[29]

The extent and manner of enforcement of contracts to make mutual wills presents difficulty especially where, as in *Stewart*, third-party beneficiaries seek enforcement. Third-party beneficiary rights are enforceable in most American jurisdictions,[30] and are established in California by both case law[31] and statute.[32] The theories upon which these rights rest, however, are frequently disputed.[33] The court in *Stewart* seems to regard equitable title to the property as vested in the remainder-

promise may serve as consideration for another promise." Note, *Separation Agreements to Make Mutual Wills for the Benefit of Third Parties*, 18 HASTINGS L.J. 423, 439 (1967). "What logical justification is there for holding mutual promises good consideration for each other? None, it submitted." Williston, *Consideration In Bilateral Contracts*, 27 HARV. L. REV. 503, 508 (1914) (*quoting* Pollock). "[I]t is also true that whatever may be the requirements of sufficient consideration, those requirements, like all rules of law, are in a broad sense dictated by public policy." *Id.* at 504-05.

[28] "Our law has no separate concept of 'will made in pursuance of contract'; we must treat the will part as a will and the contract part as a contract." T. ATKINSON, WILLS 224 (2d ed. 1963). *See* B. SPARKS, CONTRACTS TO MAKE WILLS (1956) [hereinafter cited as CONTRACTS TO MAKE WILLS].

[29] For a study of the evolution of estoppel doctrines to enforce contracts to make wills in California, see Note, *Separation Agreements to Make Mutual Wills for the Benefit of Third Parties*, 18 HASTINGS L.J. 423, 425-27 (1967), where it is asserted that the concept developed through error.

[30] Lawrence v. Fox, 20 N.Y. 268 (1859) (concerning a creditor-beneficiary), is perhaps the leading case and is said to be the forerunner of third-party beneficiary rights in the United States.

[31] The right to enforce such a contract to make a particular disposition of property on death is not restricted to the promisee. Where two parties agree to make mutual wills . . . to [benefit] certain third persons . . . the intended devisees and legatees are entitled to enforce their rights as beneficiaries under the agreement.

Brown v. Superior Ct., 34 Cal. 2d 559, 564, 212 P.2d 878, 881 (1949).

[32] CAL. CIV. CODE § 1559 (West 1954): "A contract, made expressly for the benefit of a third person, may be enforced by him at any time before the parties thereto rescind it."

[33] *See* Sparks, *supra* note 21.

men prior to decedent's remarriage,[34] and cites with approval cases treating the life tenant as a trustee for the remaindermen.[35] At the time the contract was entered into, however, no present transfer of any interest was intended; it was simply a promise to execute a document effectuating such a transfer in the future. Perhaps a more accurate statement is that the equitable title vests at the time of the promisor's death, subject to funeral and administrative expenses.[36] The closest analogy is said to be that to a contract to sell at a future date.[37] "Hence the beneficiary has an equitable right to demand a conveyance or transfer at [death] . . . , but does not have equitable title."[38] The distinction is important where the subject of the contract is "all my estate" or some other indefinite quantity;[39] fortunately, the imprecision here, where specific realty was concerned, was not fatal to correct adjudication.

The difficulties inherent in a contract to make mutual wills are sharply compounded when the policies underlying its enforcement are confronted with a contest by a pretermitted spouse.[40] "[T]he rights of the wife and widow [are] vested under a contract most strongly favored by the law . . ."[41] and the tendency of courts to give spousal rights prefer-

[34] — Cal. 2d at —, 444 P.2d at 339, 70 Cal. Rptr. at 547.

[35] *Id.* Several cases cited therein rely on "constructive trust" theories to enforce breached contracts to make mutual wills. *But see* Sparks, *supra* note 21, at 215.

[36] *In re* Stevens' Will, 192 Misc. 179, 183, 78 N.Y.S.2d 868, 872 (Sur. Ct. 1948).

[37] Sparks, *Legal Effect of Contracts To Devise or Bequeath Prior To the Death of the Promisor* (pt. I), 53 MICH. L. REV. 1, 3-4 (1954); Sparks, *supra* note 21, at 219.

[38] Sparks, *supra* note 21, at —. This view also avoids "the technical responsibilities attaching to life tenancies with frequent accounting to the probate court . . . ." Meador v. Manlove, 97 Kan. 706, 711, 156 P. 731, 733 (1916).

[39] This theory creates very serious difficulties in case of contracts to will all or a fractional part of one's estate. What is there to have a life estate in and in what does the promisee have a remainder? The promisor may consume any or all of his property during his life or he may exchange any or all of it . . . . Even it is explained that the life estate is a life estate with the power to consume, there is the further difficulty of explaining how the future acquired property is brought within the life tenant-remainderman status. It is difficult to conceive of a relationship wherein one party owns a life estate in everything possessed by him and another owns the remainder in fee, but the life tenant is capable of disposing of any or all of the property in fee simple, and any future property coming to him immediately assumes the status of a mere life estate in him and a remainder in the other party. Not only would this be a new and unusual estate, but it would be a new and unusual estate which served no useful purpose.

Sparks, *supra* note 21, at 218-19. See CONTRACTS TO MAKE WILLS 106.

[40] *See* CONTRACTS TO MAKE WILLS 167-78.

[41] Owens v. McNally, 113 Cal. 444, 453, 45 P. 710, 713 (1896).

ential treatment increases the complexity of an already complicated area of the law. Furthermore, manifestation of the deference accorded surviving spouses excluded from testamentary disposition is to be noted in various state statutes giving such spouses rights of dissent from their decedent spouses' excluding wills.[42] Most states provide for some extent of revocation, by operation of law, of wills executed prior to marriage.[43]

This legislation has recognized one or a combination of four types of such revocation.[44] A subsequent marriage may be deemed to revoke the will absolutely,[45] or merely partially revoke it, giving the surviving spouse an intestate share.[46] Or the statute may revoke the will unless it was executed in contemplation of the marriage,[47] or revoke except when a marriage contract or other arrangement provides for the surviving spouse or the spouse is so mentioned in the will as to indicate an intention that the will not be revoked by marriage.[48] These statutes reflect varying legislative appraisals of the extent to which marital rights should outweigh the privilege of free testamentary disposition.

Judicial efforts to balance the interests of excluded surviving spouses and those of the beneficiaries of the decedent's bounty in another area, inter vivos alienation of property to avoid the claims of the surviving spouse,[49] may also prove helpful by analogy, as the policies involved are similar to those considered in *Stewart*. The courts have taken various approaches to reconciling such conflicts. Perhaps these might be outlined as the "fraud" approach or New York rule,[50] the "balancing of hard-

[42] See, *e.g.*, N.C. GEN. STAT. § 30-1, -3 (1966) (right of dissent); *id.* § 29-30 (election of life estate or "statutory dower").

[43] For an annotation of state legislation in this area, see 95 C.J.S. *Wills* § 291 (1957).

[44] See Note, *Wills—Partial Revocation For the Benefit of a Pretermitted Spouse*, 17 U. MIAMI L. REV. 229 (1962).

[45] *E.g.*, ILL. REV. STAT. ch. 3, § 197 (1967); ORE. REV. STAT. § 114.130 (1965). A statute, unless expressly so providing, will not be construed to allow partial revocation; rather, the will will be struck down in its entirety. *In re* Tenner's Will, 248 N.C. 72, 102 S.E.2d 391 (1958).

[46] *E.g.*, CAL. PROB. CODE § 70 (West 1956). See note 7 *supra*. Some statutes, *e.g.*, N.C. GEN. STAT. §§ 30-1, -3 (1966), accomplish the same result by providing for dissent from the will by the surviving spouse, rather than for partial revocation.

[47] *E.g.*, CONN. GEN. STAT. REV. § 45-162 (1958).

[48] *E.g.*, CAL. PROB. CODE § 70 (West 1956). See note 7 *supra*.

[49] These efforts have focused particularly on cases where a spouse, to avoid leaving a substantial estate to his surviving spouse, has established revocable and tentative ("Totten") trusts with rights of survivorship in third parties.

[50] See *In re* Halpern's Estate, 303 N.Y. 33, 100 N.E.2d 120 (1951); Newman v. Dore, 275 N.Y. 371, 9 N.E.2d 966 (1937).

ships" approach or Maryland rule,[51] and the "estate inclusion" approach taken by the Restatement of Trusts,[52] in which the value of the inter vivos transfer is included in the decedent's estate for the purpose of determining the surviving spouse's forced heir's share, but is subjected to that obligation only if necessary and only to the extent necessary to satisfy it.[53] While these considerations in an area involving similar conflicts to those found in *Stewart* bear some relevance to that determination, their application is limited. All to some degree give weight to the decedent's intention or lack of intention to defraud the surviving spouse's marital rights.[54] Where, as in *Stewart*, the decedent in good faith contracts several years prior to the marriage, and indeed contracts with his then spouse, any application of policies based on fraudulent intent is clearly incorrect.

The status of the contesting parties is relevant,[55] but here hardly determinative. The widow was not mentioned in the will, a circumstance in which California legislation[56] seems to presume an oversight by the decedent, rather than an intention to exclude her. In her pretermitted status, then, the widow would seem deserving of judicial indulgence. Her status, however, as a second wife who did not jointly contribute to the acquisition of the property in question tends to nullify this consideration.[57] Whether the status of the contract beneficiaries entitles them to more protection is also questionable. As donee-beneficiaries, they gave "no consideration in the past, [give] none in the

[51] See Whittington v. Whittington, 205 Md. 1, 106 A.2d 72 (Ct. App. 1954).

[52] RESTATEMENT (SECOND) OF TRUSTS § 58, comment *e*, at 157-58 (1959).

[53] These various approaches were compared in Jeruzal v. Jeruzal, 269 Minn. 183, 130 N.W.2d 473 (1964), *noted in* 34 U. CIN. L. REV. 179 (1965). The court, criticizing the New York rule as inequitable and the Maryland rule as uncertain, concluded that the RESTATEMENT OF TRUSTS approach was the most satisfactory. *Id.* at 196, 130 N.W.2d at 481. *See generally* B. BOGERT, TRUSTS AND TRUSTEES § 47 (2d ed. 1965); 4 R. POWELL, REAL PROPERTY ¶¶ 569-71 (1949); A. SCOTT, LAW OF TRUSTS § 58 (3d ed. 1967); Note, *Totten Trust: The Poor Man's Will*, 42 N.C.L. REV. 214 (1963).

[54] Newman v. Dore, 275 N.Y. 371, 9 N.E.2d 966 (1937) rejects such a subjective test and implements a "real or illusory nature of the transfer" test instead; but this would seem to be merely one of a number of means of ascertaining the presence of fraudulent intent.

[55] See Ruch v. Ruch, 159 Mich. 231, 124 N.W. 52 (1909).

[56] CAL. PROB. CODE § 70 (West 1956). See note 7 *supra*.

[57] For a legislative manifestation of this view, see N.C. GEN. STAT. § 30-3(b) (1966) (giving second or successive surviving spouse dissenting from a will only one-half the amount otherwise provided as a forced heir's share by the Intestate Succession Act where the decedent has lineal descendants by a former marriage surviving, but none surviving the second or successive marriage).

present, and [promise] nothing for the future."[58] Although they are stepchildren of the decedent, he seemed by his contract and will to be disposed to treat them as his children. The decedent's intent seems on balance to have been that the property go to the stepchildren, but when the widow is taking under a forced heir's statute, this intent is clearly not entitled to much weight. Other factors entitled to judicial consideration in a given case[59] might include the length of the marriage, the widow's age and ability to support herself, and the quantum of inter vivos gifts given to her by the decedent spouse. Evidence of such factors, however, is lacking in this case.

Correct distribution of the estate involved in *Stewart* thus requires a balancing of the policy of protecting the widow from destitution against the policy of upholding the certainty of contractual obligation, and this balancing must control the decision almost to the exclusion of other factors. This approach, rather than a formal application of real property theory, should be accepted. "[O]nly those economic advantages are 'rights' which have the law back of them . . . [w]hether it is a property right is really the question to be answered."[60] That such a decision, in the absence of legislation on the point, should appropriately rest in equity jurisdiction has long been accepted. It is submitted that in the absence of a showing of hardship by the pretermitted spouse the contractual obligation should hold sway.[61]

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[58] Page, *The Power of the Contracting Parties to Alter a Contract For Rendering Performance to a Third Person*, 12 WIS. L. REV. 141, 184 (1937). Although the California statute, CAL. CIV. CODE § 1559 (West 1954) (set out at note 32 *supra*), does not distinguish between donee-beneficiaries and creditor-beneficiaries, California courts have noted the distinction. Southern Cal. Gas Co. v. ABC Constr. Co., 204 Cal. App. 2d 747, 751-52, 22 Cal. Rptr. 540, 543-44 (Dist. Ct. App. 1962).

[59] See Ruch v. Ruch, 159 Mich. 231, 124 N.W. 52 (1909).

[60] United States v. Willow River Power Co., 324 U.S. 499, 502-03 (1945) (opinion by Mr. Justice Jackson). It is asserted that the property theory has been consistently applied by the Court: "It is incorrect to say that the judiciary protected property; rather they called that property to which they accorded protection." Hamilton & Till, *Property*, in 12 ENCYCLOPEDIA OF THE SOCIAL SCIENCES 528, 536 (1934).

[61] While the arguments on both sides are cogent, it is submitted that it is better to permit a person to disinherit his future spouse than to break his contract. Hirsch, *Contracts to Devise and Bequeath* (pt. II), 9 WIS. L. REV. 388, 391 (1934); *see* Ralyea v. Venners, 155 Misc. 539, 280 N.Y.S. 8 (Sup. Ct. 1935); Burdine v. Burdine's Ex'r, 98 Va. 515, 36 S.E. 992 (1900); *but see* Ver Standig v. St. Louis Union Trust Co., 344 Mo. 880, 129 S.W.2d 905 (1939).

Copyright Law—CATV—A Plea for Legislative Revision*

A community antenna television system (CATV) is a sophisticated television receiving antenna through which signals, once received, are instantaneously amplified, separated, and relayed by coaxial cable or microwave facilities to the homes of subscribers, who pay an installation fee plus a monthly rate unrelated to the number of shows viewed. Technically a "mere adjunct of the television receiving sets [the service] enables a set disadvantageously located to operate like an ordinary set."[1] Originally it was designed to service television sets that could not receive clear signals due to mountains or distance from regular television stations.[2] In recent years, because of clearer reception and greater program variety,[3] CATV has encompassed many new markets. Hence, complex questions have arisen concerning its proper relationship to the television broadcasting industry, for until recently only the latter has been subject to regulation by the Federal Communications Commission.[4]

Local stations first became concerned over the competition for audience viewing time because CATV did not carry the local stations.[5] The

* This paper has been entered in the 1969 Nathan Burkan Memorial Competition, and is published here by permission of the American Society of Composers, Authors, and Publishers.

[1] Lilly v. United States, 238 F.2d 584, 587-88 (4th Cir. 1956). For a technical discussion of CATV systems, see generally United States v. Southwestern Cable Co., 392 U.S. 157 (1968); B. RUCKER, THE FIRST FREEDOM 175 (1968) [hereinafter cited as RUCKER].

[2] Television signals travel in a straight line and thus their direction and power are dissipated by the curvature of the earth and other factors. Five hundred thousand viewers in Manhattan, for example, do not receive adequate television signals due to the interference of tall buildings. RUCKER 175.

[3] RUCKER 176. Note, *Copyright—Telecommunication—CATV Carriage of Copyrighted Material Does Not Constitute Infringement*, 21 VAND. L. REV. 854, 856 (1968) [hereinafter cited as Note, *CATV Not Copyright Infringement*].

[4] CATV initially was not regulated by the FCC because CATV used cable facilities and was not a "broadcaster" for purposes of the Federal Communications Act, 47 U.S.C. § 153(o) (1958). Arguably, CATV should be regulated by the Common Carrier Bureau, a branch of the FCC which regulates non-broadcast services such as telephone and telegraph. Objections to such regulation are made on both historical—it does not strictly involve interstate commerce—and policy grounds. However, the microwave portion of CATV is regulated by the FCC. *See generally* Note, *The Wire Mire: The FCC and CATV*, 79 HARV. L. REV. 366 (1965); Note, *CATV and Copyright Liability: On a Clear Day You Can See Forever*, 52 VA. L. REV. 1505 (1966) [hereinafter cited as Note, *On a Clear Day*].

[5] Huntley & Phillips, *Community Antenna Television: A Regulatory Dilemma*, 18 ALA. L. REV. 64 (1965):

In most basic terms, the threat which CATV poses for the established local

FCC now requires CATV to relay the local station's broadcasts. However, the national television networks and the local stations, who had to obtain copyright licenses for their broadcasts, desired further protection from CATV as it received their programs free of charge. The copyright holders feared the potential loss of revenue when CATV sold copyrighted programs to its subscribers without paying for the programs. These parties initially sought to attack CATV in actions for unfair competition,[6] since the object of CATV was to take a share of the audience's time. The courts, however, were unanimous in refusing relief on that basis.[7] For instance, in *Cable Vision, Inc. v. KUTV, Inc.*,[8] a local station counterclaimed for damages from a CATV operator on two theories: unfair competition and tortious interference with contractual relations. The court held that the landmark cases, *Sears, Roebuck & Co. v. Stiffel Co.*[9] and *Compco Corp. v. Day-Brite Lighting, Inc.*,[10] would not permit using common law tort theories to protect what was in fact a copyright interest. "[O]nly actions for copyright infringement or such common law actions as are consistent with the primary right of public access to all in the public domain will lie."[11] An action against CATV on the basis

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television station is the threat of competition—the threat that there may be some penetration of the competitive insulation which television stations have heretofore enjoyed. . . .

Id. at 77.

[6] For a thorough treatment of the origins and developments of the law of unfair competition, see generally Chafee, *Unfair Competition*, 53 HARV. L. REV. 1289 (1940). Actions for unfair competition typically involve a seller of goods attempting to convince the consumer that his merchandise was that of a competitor, *i.e.*, "palming off." Elgin Nat'l Watch Co. v. Illinois Watch Case Co., 179 U.S. 665 (1901). See 2 R. CALLMANN, UNFAIR COMPETITION AND TRADEMARKS § 60 (2d ed. 1950); Callmann, *What is Unfair Competition?*, 28 GEO. L.J. 585 (1940). The landmark cases of Sears, Roebuck & Co. v. Stiffel Co., 376 U.S. 225 (1964), and Compco Corp. v. Day-Brite Lighting, Inc., 376 U.S. 234 (1964), held that a state unfair competition law cannot impose liability for, or prohibit, the copying of an article not protected by a patent or copyright. The Court thereby announced a firm policy of free access to anything in the public domain. For an exhaustive study of these two cases, see Bender, Brown, Derenberg, Handler & Leeds, *Product Simulation: A Right or Wrong?*, 64 COLUM. L. REV. 1178 (1964).

[7] *See, e.g.*, Intermountain Broadcasting & Telev. Corp. v. Idaho Microwave, Inc., 196 F. Supp. 315 (D. Idaho 1961); Herald Publ. Co. v. Florida Antennavision, Inc., 173 So. 2d 469 (Fla. App. 1965).

[8] 335 F.2d 348 (9th Cir. 1964), *rev'g* 211 F. Supp. 47 (D. Idaho 1962), *cert. denied*, 379 U.S. 989 (1965).

[9] 376 U.S. 225 (1964).

[10] 376 U.S. 234 (1964).

[11] 335 F.2d at 350.

[CATV may] freely and with impunity avail [itself] of such works to any extent [it] may desire and for any purpose whatever subject only to the

of copyright infringement seemed to be the only private remedy for stopping its allegedly unfair practices.

There followed an effort to require CATV to obtain copyright licenses. In *Fortnightly Corp. v. United Artists Television, Inc.*,[12] the respondent, United Artists, had given a limited license[13] for five of its copyrighted motion pictures to several television stations, which the petitioner, Fortnightly, a CATV system, had received and retransmitted to its subscribers. These subscribers could not receive any of the five television stations with ordinary antennas. At no time did the petitioner obtain any license under the copyrights from United Artists or from any of the five television stations. The respondent claimed that Fortnightly had infringed its exclusive right under the Copyright Act of 1909 to "perform . . . in public for profit" nondramatic literary works and its right to "perform . . . publicly" dramatic works.[14] Fortnightly responded that its system did not "perform" the copyrighted works at all. The district court found for United Artists, and the court of appeals affirmed. The Supreme Court reversed, holding that the CATV system of Fortnightly did not infringe the respondent's copyright.

Generally a copyright holder is not granted control over all uses of his copyrighted work by the Copyright Act,[15] but rather is given certain enumerated "exclusive rights."[16] Hence, any party, without authorization from the copyright holder, infringes the copyright when he puts a copyrighted work to a use within the scope of one of these exclusive rights.

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qualification that [it] does not steal good will, or, perhaps more accurately stated, deceive others in thinking the creations represent [its] own work. *Id.* at 351.

[12] 392 U.S. 390 (1968).

[13] *Id.* at 393. *See* Comment, *CATV—The Copyright Problem*, 13 N.Y.L.F. 395, 398 n.21 (1967) (license restricted the motion pictures to the broadcaster's facilities and gave no right to sublicense to CATV).

[14] 17 U.S.C. § 1 (1964) in pertinent part grants the copyright holder the exclusive right:

(c) To deliver, authorize delivery of . . . or present the copyrighted work in public for profit if it be a . . . nondramatic literary work . . . and to play or perform it in public for profit . . . in any manner or by any method whatsoever. . . .

(d) To perform . . . the copyrighted work publicly if it be a drama . . . and to exhibit, perform, represent, produce, or reproduce it in any manner or by any method whatsoever. . . .

[15] "The fundamental [principle is] that 'use' is not the same thing as 'infringement,' that use short of infringement is to be encouraged. . . ." B. Kaplan, AN UNHURRIED VIEW OF COPYRIGHT 57 (1967) [hereinafter cited as KAPLAN]. *See, e.g.*, Hayden v. Chalfant Press, Inc., 281 F.2d 543, 547-48 (9th Cir. 1960); Fawcett Publ., Inc. v. Elliot Publ. Co., 46 F. Supp. 717 (S.D.N.Y. 1942).

[16] See note 13 *supra*.

United Artists was granted an exclusive right to "perform in public" the five motion pictures. Thus, the main issue for determination was whether Fortnightly had performed these copyrighted works and then whether that performance was in public thereby infringing United Artists' copyright.

The *Fortnightly* case was one of first impression.[17] The main problem for the courts at each stage of the litigation was how to apply the Copyright Act, which was virtually unchanged since 1909 and had a legislative history demonstrating that problems of radio and television broadcasts were, of course, never considered.[18] The district court in *Fortnightly*,[19] relying upon a rather technical electronic analysis, reasoned that CATV rendered a public performance of the copyrighted motion pictures, as it applied energy from its own sources to reproduce and amplify the signals received from the various television broadcasts.[20] This technical approach was rejected by the court of appeals and the Supreme Court. To determine whether *Fortnightly* had "performed in public" the copyrighted material, these latter courts reviewed prior case law. These earlier cases, applying the Act to modern broadcasting methods, revealed basically three theories. These theories can conveniently be labelled the public performance, implied license, and performance theories.

The theory of public performance within the meaning of the Copyright Act was expounded in *Jerome H. Remick & Co. v. American Automobile Accessories Co.*,[21] where it was held that an unlicensed radio broadcast of a copyrighted musical composition constituted a public performance al-

[17] Previously no court had found retransmission by CATV constituted a performance. CATV was merely providing a signal and it was the subscribers themselves who were transcribing and reproducing the signal. Keller, *Is Community Antenna Television a Copyright Infringer?*, 43 U. DET. L.J. 367, 371 (1966); Note, *Community Antenna Television: Survey of a Regulatory Problem*, 52 GEO. L.J. 136, 157 (1963). Turning on a radio in one's home is considered to be a private act and therefore a non-infringing use of copyrighted material. *See generally* Herbert v. Shanley Co., 242 U.S. 591 (1917), on the requirement that the performance be for profit.

[18] The legislative history shows that the attention of Congress was directed to the situation where the dialogue of a play is transcribed by a member of the audience, and thereafter the play is produced by another with the aid of the transcript.
392 U.S. at 395 n.15.

[19] 255 F. Supp. 177 (S.D.N.Y. 1966). *See* Note, 52 IOWA L. REV. 334 (1966); Note, 42 WASH. L. REV. 649 (1967); Note, 18 W. RES. L. REV. 695 (1967).

[20] For detailed discussions of the technical aspects of this process, see Note, *CATV and Copyright Liability*, 80 HARV. L. REV. 1514, 1519 n.32 (1967); Note, *On a Clear Day* 1505; Note, *CATV Not Copyright Infringement* 857 n.12.

[21] 5 F.2d 411 (6th Cir.), *cert. denied*, 269 U.S. 556 (1925).

though the listeners enjoyed it separately and in the privacy of their homes. Reaching a large audience then constituted a public performance. A later case indicated that absent an actual broadcast, "one who enables another to hear" a performance—for example, playing a radio in a bar—would not be liable.[22] Consequently, *Fortnightly* insisted that even if it did perform, it did not do so publicly.[23] But since the petitioner reached over seventy percent of the people in the viewing area, its "rebroadcast" could not be considered private within the meaning of the public performance theory.[24] In any event, the court of appeals in *Fortnightly* dismissed this argument, stating that "it is settled that a broadcast or other transmission of a work to the public . . . results in a public performance although each individual who choses [*sic*] to enjoy it does so in private."[25]

The second theory, implied license, later limited the public performance theory. In *Buck v. Debaum*,[26] the copyright licensor was seen as giving an "implied license in law" to permit any subsequent reception and playing of the broadcast. When a copyright holder licenses a broadcaster to perform a copyrighted work, he also grants an implied license in law to receive and play the work to anyone who can do so, even though economic gain may be derived from it.[27] Hence, if an original radio broadcast were licensed, the mere playing of that radio broadcast in public would not, under the implied license theory, constitute infringement.[28] One writer asserted that the theory of implied license lies at "the heart of the question of CATV copyright liability."[29] However, the court of appeals in *Fortnightly* rejected this implied license theory, feeling that the copyright holder should have practically absolute control over his work, as the primary purpose of the Copyright Act is the protection of the holder's economic rights.[30] Still, the Solicitor General, in an amicus curiae brief

[22] Jerome H. Remick & Co. v. General Elec. Co., 16 F.2d 829 (S.D.N.Y. 1926).
[23] 392 U.S. 390, 395 n.13 (1968).
[24] Comment, *CATV—The Copyright Problem*, 13 N.Y.L.F. 395, 403 (1967).
[25] United Artists Telev., Inc. v. Fortnightly Corp., 377 F.2d 872, 879 (2d Cir. 1967).
[26] 40 F.2d 734 (S.D. Cal. 1929).
[27] *Id.* at 736. See Note, *CATV Not Copyright Infringement* 859.
[28] Comment, *CATV and Copyright Liability, The Final Decision*, 1 CONN. L. REV. 401, 402 (1968) [hereinafter cited as Comment, *The Final Decision*].
[29] Note, *CATV and Copyright Liability*, 80 HARV. L. REV. 1514, 1522 (1967). Most clearly it raises the key question of "where, if anywhere, in a chain of transmissions and public reception, the copyright owner's control should stop." KAPLAN 104 (*quoting* SUPPLEMENTARY REPORT ON THE GENERAL REVISION OF THE UNITED STATES COPYRIGHT LAW: 1965 REVISION BILL, pt. 6, at 40).
[30] The court reasoned that in the age of television and motion pictures the theory

to the Supreme Court in *Fortnightly*, proposed the implied license theory as a compromise in order to accommodate "competing considerations of copyright, communications, and antitrust policy."[31] Nevertheless, the Supreme Court in *Fortnightly* also declined to adopt the implied license theory, stating that the "job is for Congress,"[32] thus indicating the Court's reticence to legislate by judicial decision, at least in this area.

The third theory, the performance concept, was defined in *Buck v. Jewell-LaSalle Realty Co.*[33] and *Society of European Stage Authors & Composers, Inc. v. New York Hotel Statler Co.*[34] These cases establish the "multiple performance doctrine"—that even though the original broadcast is licensed, any other person who employs mechanical means to extend the original broadcast to a larger audience than the boadcast would otherwise command, may also be considered to have "performed" the copyrighted work.[35] The court of appeals in *Fortnightly* adopted this quantitative contribution test by asking, "[H]ow much did the [petitioner] do to bring about the viewing and hearing of a copyrighted work?"[36] It reasoned that CATV did much more than the hotel intercoms in *Jewell-LaSalle* and *SESAC* to increase audience size by mechanical means, so CATV clearly rendered an infringing performance.[37] The Supreme Court in *Fortnightly* rejected this multiple performance or quantitative contri-

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of implied license was clearly inconsistent with the "self-evident" right of a copyright holder to limit licenses to perform his works in public to defined periods, areas, and audiences. 377 F.2d at 877.

[31] 392 U.S. 390, 401 (1968).

[32] *Id.*

[33] 283 U.S. 191 (1930). A hotel was held liable for copyright infringement for an unauthorized public performance when it provided its guests with radio entertainment through a master radio set wired to loudspeakers or headphones throughout the building. The hotel rendered an independent performance when it received and played through this system a musical radio broadcast by a local radio station that had not obtained a license from the copyright holder to make the broadcasts.

[34] 19 F. Supp. 1 (S.D.N.Y. 1937). A hotel had installed in its rooms loudspeakers capable of receiving two stations. Even though a guest could choose between the two stations and even though the original broadcast was licensed, the hotel was found guilty of infringement. Although "the reception of a broadcast program by one who listens to it is not any part of the performance thereof," the court concluded that where a hotel "does as much as is done in the Hotel Pennsylvania to promote the reproduction . . . of a broadcast program received by it, it must be considered as giving a performance. . . ." *Id.* at 4.

[35] Buck v. Jewell-LaSalle Realty Co., 283 U.S. 191, 198, 199 n.7 (1930); Note, *CATV Not Copyright Infringement* 858.

[36] 377 F.2d at 877.

[37] The court noted the expense involved in installing antennas, cables, and connections to subscribers' television sets and that such installation was the primary business of CATV. 377 F.2d at 878.

bution test.[38] In a footnote the Supreme Court stated that *Jewell-LaSalle* was limited to its own facts, urging that if the original broadcast by the hotel had been licensed then the rebroadcast by the hotel might not be an infringement due to the implied license in law.[39] The Supreme Court concluded that unlike *Jewell-LaSalle* the original broadcast in *Fortnightly* had been authorized,[40] and therefore *Jewell-LaSalle* could not be be controlling.[41]

All three theories and the electronic analysis of the district court were rejected by the Supreme Court in *Fortnightly*. The Supreme Court stated that "resolution of the issue before us depends upon a determination of the function that CATV plays in the total process of television broadcasting and reception."[42] Traditionally, broadcasters have been deemed exhibitors, and viewers members of the theater audience. This general functional test seeks to determine where CATV falls within the framework of this broadcaster-viewer dichotomy; that is, does CATV have more in common with broadcasting or with viewing?

> When CATV is considered in this framework, we conclude that it falls on the viewer's side of the line. Essentially, a CATV system no more than enhances the viewer's capacity to receive the broadcaster's signals; it provides a well located antenna with an efficient connection to the viewer's television set. It is true that CATV system plays an "active" role in making reception possible in a given area, but so do ordinary sets and antennas.[43]

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[38] "[M]ere quantitative contribution cannot be the proper test to determine copyright liability in the context of television broadcasting." 392 U.S. at 397.

[39] 392 U.S. 390, 396 n.18 (1968). Mr. Justice Brandeis in *Jewell-LaSalle*, referring to Buck v. Debaum, 40 F.2d 734 (S.D. Cal. 1929), suggested that "[i]f the copyrighted composition had been broadcast . . . with the plaintiffs' consent, a license for its commercial reception and distribution . . . might possibly have been implied." 283 U.S. at 199 n.5. The Supreme Court in *Fortnightly* stated that "existing 'business relationships' would hardly be preserved by extending a questionable 35 year-old decision that in actual practice has not been applied outside its own factual context." 392 U.S. at 401 n.30.

[40] Some uncertainty remains in the area of multiple performance as the Court in *Fortnightly* did not discuss or distinguish *SESAC*, a case in which an infringement was found even though the original broadcast was licensed. See 392 U.S. at 405.

[41] Mr. Justice Fortas argued, in dissent, that *Jewell-LaSalle* should control and that the footnote relied upon by the majority was too vague to serve as a basis for distinction. "[T]he interpretation of the term 'perform' cannot logically turn on the question whether the material used is licensed or not licensed." 392 U.S. at 406-07 n.5.

[42] 392 U.S. at 397.

[43] 392 U.S. at 399. Although the Supreme Court used broad language in respect to CATV, there is some qualification: "While we speak in this opinion generally

The Court found that CATV rendered no performance within the meaning of the Copyright Act, viewing the primary purpose of the Copyright Act as encouraging the dissemination of copyrighted works to the public; the protection of the economic rights of the copyright holder in the fruits of his creativity was seen only as a secondary aim.[44]

Copyright and unfair competition suits have thus been discarded by the courts as a means of regulating CATV. Yet the local stations and the copyright holder seem still in need of protection. CATV is no longer an infant industry that needs to be nurtured. In fact, CATV hinders the growth of new local stations.[45] Copyright holders do not receive anything from CATV when it utilizes copyrighted broadcasts. CATV has an important place in the future of the television industry, but it cannot assume its proper position without paying for its use of copyrighted works. It is clearly unfair to allow CATV "to reap where it has not sown."[46] Neither the full imposition of copyright liability in all cases nor the complete denial of copyright liability are satisfactory answers.[47] The final determination of the requirements for CATV must be left to Congress and the FCC,[48] as the Supreme Court intimated. In a recent case decided a few weeks before *Fortnightly—United States v. Southwestern Cable Co.*[49] —the FCC was given very broad authority to regulate CATV, with no

of CATV, we necessarily do so with reference to the facts of this case." 392 U.S. at 399 n.25.

[44] 392 U.S. at 401. The Court did not rely on the implied license theory in reaching its decision since it found that the petitioner did not perform. Even if it had found a performance, there is evidence that the reasoning of Buck v. Debaum, 40 F.2d 734 (S.D. Cal. 1929), would have been adopted. The Court stated that once a program is "released to the public" it can then be carried to additional viewers by CATV systems for profit. 392 U.S. at 400.

[45] Comment, *The Final Decision* 406.

[46] Comment, *Community Antenna Television and the Copyright Law: End of the Honeymoon*, 15 U. KAN. L. REV. 325, 339 (1967).

[47] One view reasons: there is no effective way to screen all telecasts received to determine whether not they are copyrighted; therefore, to impose full copyright liability in all instances night force CATV out of business. Note, *CATV Not Copyright Infringement* 862. One writer concluded that "blanket extension of copyright liability to CATV . . . could . . . give major copyright holders not just a means of preserving their exclusive marketing arrangements, but a powerful weapon to gain control of the CATV industry itself." Note, *CATV and Copyright Liability*, 80 HARV. L. REV. 1514, 1528 (1967).

[48] As was evidenced at each level of litigation in *Fortnightly*, this complex problem cannot be resolved satisfactorily by the judiciary. The Solicitor General, as amicus curiae, recommended that the Court stay its action until Congress had acted. 392 U.S. at 404.

[49] 392 U.S. 157 (1968). The Court recognized that the FCC has broad powers under the Communications Act of 1934 to regulate CATV systems and prohibit their expansion where broadcast services to new areas would be jeopardized.

congressional mandate necessary. The FCC's previous controls over CATV have proven unsatisfactory.[50] The FCC, since 1966 when it assumed jurisdiction over CATV systems has requested clarifying guidelines from Congress, but Congress has refused.[51] Moreover, Congress deleted the provision relating to CATV in its present revision of the 1909 Copyright Act.[52] The FCC, with or without congressional guidelines, is the logical governmental agency to resolve most adequately and amicably the competing private, public, and economic interests involved in CATV transmission of copyrighted works. In light of the inaction of Congress and the *Southwestern Cable* decision, the FCC should adopt its own policies to protect the small local stations, the copyright holder, and CATV, thereby accommodating the growth of CATV and of new stations in local areas.

ERIC MILLS HOLMES

Federal Jurisdiction—Expansion of the Civil Rights Act of 1871

The Civil Rights Act of 1871[1] creates a federal cause of action for persons who are deprived of constitutionally guaranteed rights by anyone acting under color of state law. Notwithstanding the broad language,[2] courts have generally restricted the use of this statute to members of minority groups who encounter difficulty in receiving a fair hearing in state courts.[3] As a result, the unlawful actions that most often have been

[50] For excellent discussions of this aspect of the CATV dilemma see Note, *The Wire Mire: The FCC and CATV*, 79 HARV. L. REV. 366 (1965); Note, *On a Clear Day* 1505. The authority of the FCC to act is unclear, and requests for clarifying guidelines from Congress have, to date, received no final action. RUCKER 178.

[51] It has been most difficult to get Congress to act because of the pressure from broadcasters and CATV lobbies. Note, *CATV Not Copyright Infringment*, 863 n.45. One writer stated that the "reason for all the delays . . . was because nearly a third of the Senate had at least remote financial interests in CATV." Comment, *The Final Decision* 406.

[52] For a summary of the present state of the copyright revision bill, see 392 U.S. at 396 n.17.

[1] 42 U.S.C. § 1983 (1964).

[2] Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress.

Id.

[3] *See, e.g.*, Lee v. Washington, 390 U.S. 333 (1968) (Negroes); CORE v.

dealt with include racial segregation in public accommodations and facilities[4] and in educational facilities,[5] unequal employment opportunities,[6] and similar acts of discrimination.

The judicial limitations on the use of the statute apparently are based on its history and the supposed intent of Congress. The main purpose of the Civil Rights Act was to aid Negroes in their struggle to gain full constitutional rights as guaranteed them by the fourteenth amendment.[7] Conditions that existed in the United States at the time of passage,[8] the title of the bill,[9] and the legislative history[10] all indicate a purpose to help Negroes gain their full rights. In the United States Supreme Court case of *Haig v. CIO*,[11] Justice Stone indicated that the statute should be used to enforce civil rights only. Pointing out that a jurisdictional amount is required for general federal question jurisdiction,[12] whereas no minimum amount in controversy is required for jurisdiction under section 1983, he reasoned that litigants should not be allowed to evade the jurisdictional amount requirement by invoking section 1983 when their claim was capable of monetary evaluation. The Supreme Court, in the later cases of *McNeese v. Board of Education*[13] and *Monroe v. Pape*,[14] concluded that

Norwalk Redev. Agency, 395 F.2d 920 (2d Cir. 1968) (Negroes and Puerto Ricans); Wright v. McMann, 387 F.2d 519 (2d Cir. 1967) (state prisoners); *contra, e.g.*, Jordan v. Kelly, 223 F. Supp. 731 (W.D. Mo. 1963).

[4] *See, e.g.*, Fleming v. South Carolina Elec. & Gas Co., 239 F.2d 277 (4th Cir. 1956) (segregated bus seating); Brooks v. Tallahassee, 202 F. Supp. 56 (N.D. Fla. 1961) (separate waiting rooms and lunch counters at municipal airport); Williams v. Kansas City, 104 F. Supp. 848 (W.D. Mo. 1952), *aff'd*, 205 F.2d 47 (8th Cir.), *cert. denied*, 346 U.S. 826 (1953) (denial of admission to municipal swimming pool).

[5] *See, e.g.*, Hill v. Board of Educ., 390 F.2d 583 (6th Cir. 1968) (Negro teacher's right to employment when school integrated); School Bd. v. Kilby, 259 F.2d 497 (4th Cir. 1958) (school open for white students only); Holmes v. Danner, 191 F. Supp. 394 (M.D. Ga. 1961) (admission to public college).

[6] *See, e.g.*, Birnbaum v. Trussell, 371 F.2d 672 (2d Cir. 1966) (Negro physician); Jordan v. Hutcheson, 323 F.2d 597 (4th Cir. 1963) (Negro attorneys).

[7] Monroe v. Pape, 365 U.S. 167, 171 (1961); Ethridge v. Rhodes, 268 F. Supp. 83, 88 (S.D. Ohio 1967); United States *ex rel.* Wakeley v. Pennsylvania, 247 F. Supp. 7, 10 (E.D. Pa. 1965); Francis v. Lyman, 108 F. Supp. 884, 888 (D. Mass. 1952), *aff'd*, 203 F.2d 809 (1st Cir. 1953).

[8] *See* Monroe v. Pape, 365 U.S. 167, 173-74 (1961).

[9] "An Act to enforce the Provisions of the Fourteenth Amendment to the Constitution of the United States, and for other Purposes." 17 Stat. 13 (1871). The popular name was the Ku Klux Act of April 20, 1871.

[10] *See generally* Monroe v. Pape, 365 U.S. 167, 171-87 (1961).

[11] 307 U.S. 496 (1939).

[12] 28 U.S.C. § 1331 (1964).

[13] 373 U.S. 668 (1963).

[14] 365 U.S. 167 (1961).

the statute was passed to provide a remedy where none was available.[15] Implicit in these decisions is the Court's recognition of Congressional intent to help minority groups, since members of the dominant group usually receive a fair hearing in state courts.[16]

Two recent cases, however, held that federal courts had jurisdiction under this statute even though the historic minority group test was not met. In *Joseph v. Rowlen*,[17] plaintiff was selling cooking utensils on the street when he was arrested by defendant-policeman. Plaintiff alleged that the arrest was made upon the basis of second-hand, unsupported reports that he was annoying pedestrians and was, therefore, without probable cause and in violation of the due process clause. The federal district court directed a verdict for defendant, holding that the deprivation of rights complained of must be part of a systematic policy of discrimination against a class or group of persons to support a claim under section 1983.[18] The court of appeals, however, ruled that the cases relied on by the district court were no longer valid[19] and remanded the case for trial.

In *Meredith v. Allen County War Memorial Hospital Commission*,[20] plaintiff, a physician on the staff of the county hospital, was refused reappointment to the staff following a hearing by the commission, which, plaintiff alleged, did not comport with the requirements of due process. The district court dismissed for lack of subject matter jurisdiction, apparently upon reasoning similar to that used by the district court in *Joseph*.[21] But the court of appeals, neglecting the question of plaintiff's status to sue, addressed itself to questions dealing with whether the defendants could be held liable under the statute and whether a guaranteed right of plaintiff's had been denied him. All literal elements of the statute being met, the district court was held to have jurisdiction, and the case was remanded for trial.[22]

The jurisdictional facts in these two cases are dissimilar to cases in which the courts historically have recognized jurisdiction under section 1983. In one case a policeman apparently made an error in judgment

[15] 373 U.S. at 671-72; 365 U.S. at 480. For an example of a lower court's view, see Romero v. Weakley, 226 F.2d 399 (9th Cir. 1955).

[16] *Contra, e.g.*, Jordan v. Kelly, 223 F. Supp. 731 (W.D. Mo. 1963).

[17] 402 F.2d 367 (7th Cir. 1968). The district court's opinion was not published.

[18] 402 F.2d at 368-69. The cases relied on were Truitt v. Illinois, 278 F.2d 819 (7th Cir. 1960); Stift v. Lynch, 267 F.2d 237 (7th Cir. 1959).

[19] 402 F.2d at 369.

[20] 397 F.2d 33 (6th Cir. 1968). The district court's opinion was not published.

[21] *See id.* at 36 (dissenting opinion of Phillips, J.).

[22] 397 F.2d at 34-36.

by arresting a salesman without probable cause; in the other, a hospital board failed to allow a doctor to answer charges of misconduct before dismissing him. There was neither claim nor evidence of minority group discrimination. On the contrary, it was implicit in the results reached by the trial courts that none was involved.

The court of appeals in *Joseph* indicated a belief that the minority group test had not survived the Supreme Court decision in *Monroe v. Pape*.[23] In *Monroe*, the same court of appeals had upheld a finding of no jurisdiction when Monroe accused Pape, a police officer, of illegal entry and search of his home.[24] The Supreme Court, however, reversed,[25] holding that an entry exceeding a policeman's authority was under color of state law. It further held that there is no requirement for jurisdiction under section 1983 that plaintiff's rights be abridged as a result of "a specific intent to deprive a person of a federal right,"[26] but that the statute should be used to "afford a federal right in federal court because, by reason of prejudice, passion, neglect, intolerance or otherwise, state laws might not be enforced . . . ."[27]

Although the Supreme Court did not mention the minority group test,[28] the court of appeals indicated that the language that eliminated the specific intent test also required discontinuing the minority group test. Monroe, however, was a member of a minority group;[29] thus, even if the Court had indicated that the minority group test was not a requirement for jurisdiction under section 1983, it would have been dictum. Since the Supreme Court's lengthy and thorough opinion explicitly eliminated only the requirement of a specific intent to deprive federal rights, the decision in *Monroe* did not necessarily require the abandonment of the minority group test in determining jurisdiction under section 1983.[30]

In *Meredith*, the court of appeals concerned itself with the problems of "under color of" state law, the requirements of due process, and the defenses and immunities raised by defendants.[31] It apparently read the language of the statute strictly as written and neglected to consider the

[23] 365 U.S. 167 (1961).
[24] Monroe v. Pape, 272 F.2d 365 (7th Cir. 1959).
[25] 365 U.S. 167 (1961).
[26] *Id.* at 187.
[27] *Id.* at 180.
[28] 402 F.2d at 369.
[29] 365 U.S. at 203.
[30] *But cf.* Cohen v. Norris, 300 F.2d 24, 29 (9th Cir. 1962), expressly overruling a similar doctrine, after *Monroe* was decided by the Supreme Court.
[31] 397 F.2d at 35-36.

limitation generally imposed by judicial interpretation. Although apparent Congressional intent should not be absolutely binding in the interpretation of enactments, such a clearly expressed and judicially accepted intent[32] should not be be ignored without explanation.[33]

Various courts, including the one that decided *Joseph*, have denounced the desirability or intention of transforming every case in which a plaintiff can urge state discrimination into a federal action.[34] That result seems inevitable, however, if the decisions in *Joseph* and *Meredith* are followed. It may not be desirable to allow this new source of cases into federal courts in situations where the state court is both available and effective, and is in fact often the court best suited to decide the case.[35] Increasingly evident today is a desire to restrict federal jurisdiction. Many federal courts more readily abstain from hearing questions that could be decided on state law,[36] and there are proposals to limit federal jurisdiction by statute.[37] To needlessly expand the jurisdiction—and consequently the workloads—of the federal courts through an expanded interpretation of section 1983 seems undesirable.

CHARLES M. BROWN, JR.

Federal Jurisdiction—Manufactured Diversity Disassembled

In the recent case of *McSparren v. Weist*,[1] the Court of Appeals for the Third Circuit, reversing its own prior decisions, held that the appointment of an out-of-state guardian of a minor for the purpose of creating diversity was an assignment improperly invoking jurisdiction under

[32] Cases cited notes 7-15 *supra*.

[33] *See* Frankfurter, *Some Reflections on the Reading of Statutes*, 47 COLUM. L. REV. 527 (1947).

[34] 402 F.2d at 369 & n.6.

[35] *See generally* ALI, STUDY OF THE DIVISION OF JURISDICTION BETWEEN STATE AND FEDERAL COURTS (1965); Marden, *Reshaping Diversity Jurisdiction*, 54 A.B.A.J. 453, 455 (1968).

[36] Although the recent cases of Dombrowski v. Pfister, 380 U.S. 479 (1965), and Baggett v. Bullitt, 377 U.S. 360 (1964), have expanded the use of pendent jurisdiction by restricting the doctrine of abstention, the lower federal courts still abstain in many cases. See, *e.g.*, Zwickler v. Koota, 261 F. Supp. 985 (1966), *rev'd*, 389 U.S. 241 (1967). It is a widely held belief that "state courts should be the primary source of interpretation and application of state law." Marden, *Reshaping Diversity Jurisdiction*, 54 A.B.A.J. 453, 455 (1968).

[37] *See* ALI, STUDY OF THE DIVISION OF JURISDICTION BETWEEN STATE AND FEDERAL COURTS (1965).

[1] 402 F.2d 867 (3d Cir. 1968).

section 1359 of Title 28 of the United States Code.[2] In *McSparren*, a minor, a citizen of Pennsylvania, was injured in an automobile accident involving another Pennsylvania citizen. The accident occurred in the county where the minor resided with his mother. The Pennsylvania Orphans Court granted a petition for the appointment of an out-of-state guardian for the estate of the minor.[3] Subsequently, this guardian instituted suit in the federal district court against the Pennsylvania driver. The district court granted the defendant's motion to dismiss for lack of diversity jurisdiction,[4] and the court of appeals affirmed.

The manufacturing of diversity jurisdiction in the federal courts is hardly a new problem. In the original Judiciary Act of 1789 Congress enacted the "assignee clause" to prevent the manufacture of diversity jurisdiction through the assignment device.[5] In *Sowell v. Federal Reserve Bank*,[6] the Supreme Court stated that the history of the assignee clause "shows clearly that its purpose and effect, at the time of enactment, were to prevent the conferring of jurisdiction on the federal courts, on grounds of diversity of citizenship, by assignment, in cases where it would not otherwise exist . . . ."[7] The assignee clause was replaced in 1948 by the present 28 U.S.C. § 1359, which denies the district court jurisdiction of any case in which "any party, by assignment or otherwise, has been improperly or collusively made or joined to invoke the jurisdiction of such court."[8] Section 1359 was derived from former sections 41(1) and 80,[9] and the focal words of section 80, "improperly or collusively," were incorporated into Section 1359 and were probably intended by Congress "to have the same meaning and connotation which had been given them at the time of incorporation into the Revised Code."[10]

Despite the avowed purpose of these statutes, they have not posed any particular difficulty to those persons seeking to invoke federal jurisdiction

[2] 28 U.S.C. § 1359 (1964).

[3] It was admitted that the only funds that would pass into the guardian's hands would be the funds obtained by suit or settlement in an action that the guardian would bring in federal district court. 402 F.2d at 868.

[4] McSparren v. Weist, 270 F. Supp. 421 (E.D. Pa. 1967).

[5] Judiciary Act of 1789, ch. 20, § 11, 1 Stat. 78; see Legislative History, Revisor's Notes *to* 28 U.S.C. § 1359 (1964); H. HART and H. WECHSLER, THE FEDERAL COURTS AND THE FEDERAL SYSTEM 918 (1953).

[6] 268 U.S. 449 (1925).

[7] *Id.* at 453.

[8] 28 U.S.C. § 1359 (1964).

[9] Legislative History, Revisor's Notes *to* 28 U.S.C. § 1359 (1964).

[10] Bradbury v. Dennis, 310 F.2d 73, 74 (10th Cir. 1962); *see* Legislative History, Revisor's Notes *to* 28 U.S.C. § 1359 (1964).

by the manufacture of diversity. In the classic case of *Black and White Taxicab & Transfer Co. v. Brown & Yellow Taxicab & Transfer Co.*,[11] a Kentucky corporation wishing to bring suit in federal court upon a contract, void under Kentucky law, dissolved the Kentucky entity and reincorporated in Tennessee. The ostensible purpose of this action was to create diversity of citizenship. In upholding the jurisdiction of the federal court, the Supreme Court held that "[t]he succession and transfer were actual, not feigned or merely colorable. In these circumstances, courts will not inquire into motives when deciding concerning their jurisdiction."[12] Subsequently, in *Jaffe v. Philadelphia & Western Railroad*,[13] the third circuit upheld the manufacture of jurisdiction in a wrongful death action. The deceased was a resident of Pennsylvania, as was the defendant corporation. For the admitted purpose of bringing the suit in federal court, an out-of-state resident was appointed administratrix of the deceased's estate.[14] In upholding federal jurisdiction, the court of appeals relied heavily upon *Mecom v. Fitzsimmons Drilling Co.*,[15] where it was stated:

> To go behind the decree of the probate court would be collaterally to attack it, not for lack of jurisdiction of the subject-matter or absence of jurisdictional facts, but to inquire into purposes and motives of the parties before that court when, confessedly, they practiced no fraud upon it.[16]

In *Mecom*, however, the purpose of the appointment of an out-of-state administrator was to *defeat* diversity jurisdiction and to prevent the removal of the suit from the state court to the federal court.[17] Although there is a federal policy against manufacturing federal jurisdiction, "there is no federal legislative policy against an avoidance of federal jurisdiction."[18] Following the line of reasoning begun in *Jaffe*, the third circuit

[11] 276 U.S. 518 (1928).

[12] *Id.* at 524. *But cf.* Miller & Lux, Inc. v. East Side Canal & Irrig. Co., 211 U.S. 293 (1908), where the Court found no federal jurisdiction because, although a new corporation was formed in another state, the old corporation had not been dissolved.

[13] 180 F.2d 1010 (3d Cir. 1950). At the time suit was filed 28 U.S.C. § 80 (1940) was in effect. This provision was replaced in 1948. *See* 28 U.S.C. § 1332 (1964).

[14] 180 F.2d at 1011. The non-resident administratrix was a stenographer in the office of the widow's attorney.

[15] 284 U.S. 183 (1931).

[16] *Id.* at 189.

[17] *Id.* at 185.

[18] 3A J. MOORE, FEDERAL PRACTICE ¶ 17.05 [2], at 152 (1968).

again approved the manufacture of federal jurisdiction in *Corabi v. Auto Racing, Inc.*,[19] where the resident administratrix resigned to permit the appointment of a non-resident so that suit could be brought in federal court. The court held that section 1359 did not bar the action; there was no collusion involved and the action was not improperly brought in federal court since there was no impropriety or irregularity involved in the valid state court proceeding for the appointment of the out-of-state fiduciary.[20]

The interpretation given section 1359 by the court in *Corabi* has made the case the "authoritative foundation for the maintenance of 'manufactured' diversity jurisdiction."[21] For instance, in *County of Todd v. Loegering*,[22] the court found nothing "improper" or "collusive" although the motive for the appointment of the out-of-state trustee was clearly to manufacture diversity. In fact, the court stated that "[t]hese are the usual expendients employed by counsel and client in matters of this kind."[23]

The rationale of *Corabi* has also been applied by other circuits to the appointment[24] of administrators and guardians.[25] In *Lang v. Elm City Construction Co.*,[26] the second circuit upheld jurisdiction although the original administratix had resigned solely to permit the appointment of the non-resident administrator to obtain the requisite diversity. The Connecticut District Court, following the *Corabi* decision, stated that "[w]hile the decision of the Third Circuit in *Corabi* is not controlling on this Court, it is persuasive and will be followed, absent a decision on the question by the Supreme Court or the Second Circuit."[27]

Another egregious example of the manufacture of jurisdiction was *City of Eufaula v. Pappas*,[28] where the resident owners of land subject to condemnation proceedings quitclaimed their interests to a non-resident member of the family for consideration of one dollar. Again the only

[19] 264 F.2d 784 (3d Cir. 1959). Approved at the same time was Jamison v. Kammerer, 264 F.2d 789 (3d Cir.), *cert. denied*, 361 U.S. 813 (1959).

[20] 264 F.2d at 788.

[21] McSparren v. Weist, 402 F.2d 867, 872 (3d Cir. 1968).

[22] 297 F.2d 470 (8th Cir. 1961).

[23] *Id.* at 474.

[24] Janzen v. Goos, 302 F.2d 421 (8th Cir. 1962). At the time the appointment was made plaintiff and defendant were fellow Nebraska citizens; prior to filing suit, plaintiff moved to Kansas. The court upheld diversity jurisdiction.

[25] Stephan v. Marlin Firearms Co., 325 F.2d 238 (2d Cir. 1963).

[26] 217 F. Supp. 873 (D. Conn.), *aff'd*, 324 F.2d 235 (2d Cir. 1963) (per curiam).

[27] 217 F. Supp. at 877.

[28] 213 F. Supp. 749 (M.D. Ala. 1963).

purpose of the transaction was to create diversity, and it was conceded that whatever sum was awarded would be divided among the grantors in proportion to the interest that they had conveyed.[29] Under Alabama law the consideration of one dollar was sufficient to support the transfer and consequently the court upheld the federal jurisdiction, on a rationale similar to that in the *Taxicab* case. Perhaps this case goes even beyond the *Taxicab* case because of the simplicity of the transaction that created diversity—obviously it is more difficult to dissolve a corporation, complying with state laws, than to transfer an interest in property by quitclaim deed.

Corabi and the cases following the rationale of that decision have been criticized for their interpretation of section 1359. Recently, in *Caribbean Mills, Inc. v. Kramer*,[30] the court did not allow the assignment of a claim from a Panama corporation to a Texas citizen when admittedly the purpose was to invoke federal jurisdiction and the only duty of the assignee was to collect the claim. In discussing *Corabi*, the court stated that "[b]y focusing on the literal meaning of the two words [improperly and collusively], the Court [in *Corabi*] virtually emasculated the statute . . . ."[31] Similarly, the court in *Ferrara v. Philadelphia Laboratories, Inc.*[32] dismissed for want of jurisdiction where the claims of the injured party were assigned to a non-resident trustee in order to invoke federal jurisdiction. The question whether the plaintiff was "improperly or collusively" made a party was held dependent upon whether the transfer was "real."[33] The court set out several factors to be considered in determining whether or not the transaction was "real" and not "merely colorable" or "fictitious": (1) the transferor's retention of an interest in the subject matter, outcome or control of the litigation;[34] (2) the mo-

[29] *Id.* at 750.

[30] 392 F.2d 387 (5th Cir. 1968); *See* 3A J. MOORE, FEDERAL PRACTICE ¶ 17.05 [3.-3] (1968); Cohen & Tate, *Manufacturing Diversity Jurisdiction by the Appointment of Representatives: Its Legality and Propriety*, 1 VILL. L. REV. 201 (1956).

[31] 392 F.2d at 393.

[32] 272 F. Supp. 1000 (D. Vt. 1967), *aff'd on opinion below*, 393 F.2d 934 (2d Cir. 1968).

[33] 272 F. Supp. 1000, 1012 (D. Vt. 1967).

> The defendants' challenge to jurisdiction under § 1359 is not overcome by demonstrating that the trust instruments . . . are valid and legally binding between the parties to it under state law. A 'valid' transfer . . . is not synonymous with a 'real' transfer in the sense that term is used to delineate jurisdictional limits under the statute.

Id. at 1008. *See also* Note, *Appointment of Non-Resident Administrators to Create Federal Diversity Jurisdiction*, 73 YALE L.J. 873 (1963).

[34] 272 F. Supp. at 1008-11.

tive or purpose of the transfer;[35] (3) the transferor's solicitation of the plaintiff to bring suit, promising reimbursement for costs and expenses.[36] Even cases in the third circuit following *Corabi* admit that the decision "may seem inconsistent with the intention of the authors of our Constitution and may force the federal courts to decide difficult questions of state law that might well be avoided . . . ."[37]

In light of this problem the American Law Institute has proposed two statutory changes that would severely curtail the manufacture of diversity jurisdiction.[38] Proposed section 1301(b)(4)[39] "is designed to prevent either the creation or the defeat of diversity jurisdiction by the appointment of a representative having a different citizenship from the infant, incompetent, or decedent he is appointed to represent."[40] These representatives will be deemed citizens only of the same state as the person represented. "Although the major impetus for this subsection was the practice of manufacturing diversity in wrongful death cases, it applies in terms to an action of any type by an executor or administrator."[41] Another section of the proposed legislation "deals with appointments of other types of officers or individuals to such positions as receivers of debtors' estates, trustees, and the like, and makes the jurisdiction turn on the same test as is applicable to other business assignments—whether *an object* of the appointment or transfer was creation of access to a federal forum."[42]

The elimination of the manufactured diversity suits would apparently significantly reduce the case loads in the federal courts. For example, in a sample of cases from the Eastern District of Pennsylvania, it was determined that 20.5 per cent of the diversity suits were manufactured.[43] The general tenor of the ALI's proposals is to curtail federal jurisdiction, the justification being that the federal courts "should not be called

[35] *Id.* at 1011-12.

[36] *Id.* at 1013-15. *Corabi* was distinguished on the grounds that there was an appointment of a non-resident administrator by a decree of a state court; in *Ferrara*, there was a transfer to the non-resident directly from the beneficiaries of the litigation.

[37] Greene v. Basti, 391 F.2d 892, 893-94 n.1 (3d Cir. 1968).

[38] ALI STUDY OF THE DIVISION OF JURISDICTION BETWEEN STATE AND FEDERAL COURTS, pt. I (Official Draft 1965) [hereinafter cited as ALI STUDY].

[39] *Id.* at 9.

[40] *Id.* at 61.

[41] *Id.* at 63.

[42] *Id.* at 102-03 (emphasis added).

[43] *Id.* at 175 n.7. More than 1,000 cases, filed between November 10, 1958 and July 7, 1959, were studied. *Id.* 173 & n.3.

upon for the administration of state law . . . unless there is some special reason for their intervention . . . ."[44] Even those who would disagree with the study as a whole[45] would "favor a prohibition against the manufacture of diversity jurisdiction by the appointment of an out-of-state personal representative or by a colorable assignment or otherwise."[46]

In *McSparren* the court chose to reëvaluate its prior interpretation of section 1359, recognizing that "there would be no need for such legislation in 'manufactured' diversity cases but for the interpretation of section 1359 in our leading case of *Corabi*, and similar decisions."[47] The court determined that when the sole motive for the appointment of a non-resident is to create diversity, it is "improper" under section 1359; therefore, a district court shall not have jurisdiction of the action. The third circuit's decision overruling *Corabi* and *Jaffe* conflicts with the view that the motive for the appointment of non-residents is immaterial.[48] It has been argued that the holding in *McSparren* will result in the collateral attack of valid state court proceedings.[49] However, the appointment of the guardian can stand for other purposes, even though the federal court will not allow him to bring the suit on the basis of diversity.[50]

There apparently, then, is little justification in allowing a manufactured diversity suit to be brought in federal court. Historically, the basis for the federal forum in diversity cases was fear of prejudicing the out-of-state litigants.[51] In those cases where diversity is manufactured, however, the genuine parties are citizens of the same state, and the cause of action is actually of a local nature. Therefore, the state courts would seem to be the proper tribunal.

The ALI's proposed legislation furnishes a "bright line" objective test for refusing federal jurisdiction. If the citizenship of the appointed repre-

[44] *Id., Foreword* at ix.

[45] Frank, *Federal Diversity Jurisditcion—An Opposing View*, 17 S.C.L. REV. 677 (1965); Moore & Weckstein, *Diversity Jurisdiction: Past, Present, and Future*, 43 TEXAS L. REV. 1 (1964).

[46] Moore & Weckstein, *Diversity Jurisdiction: Past, Present, and Future*, 43 TEXAS L. REV. 1, 35 (1964).

[47] 402 F.2d at 873.

[48] In *Corabi* the court stated "[w]e cannot distinguish the facts of the Taxicab Company case in any practical way from those of the case at bar." 264 F.2d at 787. It seems the words "collusive" and "improper" imply that the motive must be determined.

[49] Esposito v. Emory, 402 F.2d 878, 880 (3d Cir. 1968) (dissenting opinion).

[50] "Neither would the federal court's refusal to allow diversity jurisdiction impugn in any way or collaterally attack the validity of the state court appointment." 3A J. MOORE, FEDERAL PRACTICE ¶ 17.05 [3.-3], at 165 (1968).

[51] See ALI STUDY 47-56.

sentative is different from the citizenship of the infant, incompetent, or decedent, the citizenship of the one being represented automatically controls. Also, the rewording of the assignment clause to deprive the district court of jurisdiction over the parties whenever *an object* of the transaction is to invoke or to defeat federal jurisdiction is more stringent than the present statute.[52]

Thus, in view of the increasing criticism and study of the concept of manufactured diversity jurisdiction, the result of *McSparren v. Weist* was not unexpected. Although *McSparren* is a move in the right direction, the decision leaves several questions unanswered. The court held where the *sole* purpose of the appointment of a foreign representative is to create diversity the action is "improper" and therefore "offends against § 1359."[53] This leaves open to litigation the question whether the appointment has as its (1) *sole* purpose (2) its *principal* purpose or (3) *one* of its purposes the manufacture of diversity.[54] Although barred by prior Supreme Court decisions,[55] it seems that the better test would be to look to the citizenship of the deceased, minor, or incompetent for purposes of deciding jurisdiction.

MICKEY A. HERRIN

Federal Taxation—Unreasonable Corporate Accumulation and the "Any Purpose" Test

"It can be contended that every corporation, when organized, has as one of its purposes, the avoidance of surtax."[1] Though this may be true

[52] *Id.* at 102. "Ordinarily, the absolute transfer of property for valuable consideration would negative any conclusion that an object of the transfer was to create diversity." *Id.* The proposed statute would certainly change the result in *City of Eufaula.*

[53] 402 F.2d at 876. Apparently the holding would not include the situation where the original administrator resigns, because in this instance someone must be appointed before the suit can be brought.

[54] Amalgamated Clothing Workers v. Curlee Clothing Co., 19 F.2d 439 (8th Cir. 1927). A corporation's reincorporation in another state, though defective, was interpreted to be permanent. Acquiring federal jurisdiction was only one consideration, and probably a minor one, for the change. Federal jurisdiction was upheld. *Id.* at 440. If attorneys begin to choose as foreign representatives out-of-state relatives with a legitimate interest in the litigation, then the question would be squarely presented to the court.

[55] Mexican Cent. Ry. v. Eckman, 187 U.S. 429 (1903); Rice v. Houston, 80 U.S. (13 Wall.) 66 (1871); Chappedelaine v. Dechenaux, 8 U.S. (4 Cranch.) 306 (1808).

[1] Halperin, *The Surtax on Corporations Improperly Accumulating Surplus*, 18 TAXES 72, 76 (1940).

in a theoretical sense, Congress has not sought to penalize such a purpose when it is merely a normal incident of the use of the corporate form. When, however, the corporation is "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders . . . by permitting earnings and profits to accumulate instead of being divided or distributed,"[2] Congress has imposed virtually a confiscatory surtax on these accumulated earnings.[3] The purpose of the tax is to compel the company to distribute any profits not needed for the conduct of its business so that shareholders may be taxed on the dividends received.[4]

Before the tax is imposed, it must first be shown that the accumulation is unreasonable;[5] this is a relatively objective test and most of the cases under the statute have been concerned with its determination.[6] A basic issue, however, remains whether or not the tax avoidance purpose is present in the decision to accumulate.[7] This proof—that the corporation was "formed or availed of for the purpose of tax avoidance"[8]—is necessarily subjective in nature.[9] Congress, therefore, has provided that

[2] INT. REV. CODE OF 1954, § 532(a). The basic provisions of the accumulated earnings tax, now found in INT. REV. CODE of 1954, §§ 531-37, have been in existence since 1921 and remain substantially unchanged. See Revenue Act of 1921, § 220, 42 Stat. 247.

[3] Section 531 imposes a tax of 27½ percent of the accumulated taxable income not in excess of 100,000 dollars, plus 38½ percent of the accumulated taxable income in excess of 100,000 dollars. INT. REV. CODE of 1954, § 531.

[4] Helvering v. Chicago Stock Yards Co., 318 U.S. 693, 699 (1943).

[5] INT. REV. CODE of 1954, § 533(a). It is interesting to note that in this regard Congress has provided one of those rare instances in which the taxpayer can shift the burden of proof to the government. INT. REV. CODE of 1954, § 534. The value of this shift, however, is not so great as it might first appear. As it has been pointed out, "[t]he reasonable needs of the business is really a subsidiary question . . . The burden of proof as to the ultimate question, whether the taxpayer corporation has been availed of for the purpose of avoiding tax on its stockholders, always remains with the taxpayer." Hammond & Victor, *The Accumulated Earnings Tax*, 9 PRAC. LAW. No. 8, 1963, at 92.

[6] *E.g.*, Pelton Steel Casting Co. v. Commissioner, 251 F.2d 278 (7th Cir.), *cert. denied*, 356 U.S. 958 (1958). Discussion of what factors are relevant in determining the reasonableness of the accumulation is beyond the scope of this note. See generally Treas. Reg. § 1.533-1(a)(2) (1959); Carey, *Accumulations Beyond the Reasonable Needs of the Business: The Dilemma of Section 102(c)*, 60 HARV. L. REV. 1282 (1947); Hernitz, *Stock Redemptions and the Accumulated Earnings Tax*, 74 HARV. L. REV. 866 (1961); Note, *Accumulated Earnings and the Reasonableness Test of Section 537*, 43 TUL. L. REV. 129 (1968).

[7] See Shaw-Walker Co. v. Commissioner, 390 F.2d 205, 214 (6th Cir. 1968), *vacated and remanded*, 89 S. Ct. 707 (1969) (per curiam).

[8] INT. REV. CODE of 1954, § 532(a).

[9] See Casey v. Commissioner, 267 F.2d 26, 32 (2d Cir. 1959) (concurring opinion). One writer has pointed out that

> proof of state of mind is always fraught with difficulty. Direct evidence is

the fact that the corporation's profits and earnings are allowed to accumulate beyond the reasonable needs of the business shall be determinative of the proscribed purpose unless the contrary is proven by the preponderance of the evidence.[10]

If there is an unreasonable accumulation of income, what must the taxpayer do to show by a "preponderance of the evidence" that the tax avoidance motive was absent? Prior to the Supreme Court's recent decision in *United States v. Donruss Company*,[11] the courts were divided over the issue. Three distinct tests were applied in deciding when there was sufficient tax avoidance purpose to impose the surtax: (1) tax avoidance must be the "dominant, controlling, or impelling" motive,[12] (2) it must be one of the "determinating purposes" in the decision to accumulate,[13] and (3) it is sufficient if "any purpose" is tax avoidance.[14] In resolving this conflict, the Supreme Court adopted the "any purpose" test, *i.e.*, the government's contention that "it is sufficient if [tax avoidance] is one of the purposes for the company's accumulation policy."[15]

The Donruss Company had increased its accumulated earnings over a six year period from 1.02 to 1.67 million dollars. During this period the sole shareholder had received no income from the business other than his normal salary. In a suit for refund of the penalty tax, the jury found that although the accumulation was beyond the reasonable needs of the business, there had been no tax avoidance purpose present.[16] The court of appeals reversed the judgment entered on the verdict because the charge

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usually unavailable, and reliance must be placed on inferences from the surrounding circumstances. In addition, the taxpayer here is always a corporation, and resort must therefore be had to the motives of the individuals in control of the corporation since, of course, it can have no independent state of mind.

Herwitz, *Stock Redemptions and the Accumulated Earnings Tax*, 74 HARV. L. REV. 866, 869 (1961).

[10] INT. REV. CODE of 1954, § 533(a).

[11] 89 S. Ct. 501 (1969).

[12] Donruss Co. v. United States, 384 F.2d 292, 296 (6th Cir. 1967); *accord*, Young Mtr. Co. v. Commissioner, 281 F.2d 488 (1st Cir. 1960).

[13] Kerr-Cochran, Inc. v. Commissioner, 253 F.2d 121 (8th Cir. 1958); *accord*, World Publ. Co. v. United States, 169 F.2d 186 (10th Cir. 1948), *cert. denied*, 335 U.S. 911 (1949).

[14] R.L. Blaffer & Co. v. Commissioner, 37 B.T.A. 851 (1937), *aff'd*, 103 F.2d 487 (5th Cir.), *cert. denied*, 308 U.S. 576 (1939); *accord*, Barrow Mfg. Co. v. Commissioner, 294 F.2d 79 (5th Cir. 1961), *cert. denied*, 369 U.S. 817 (1962); Pelton Steel Casting Co. v. Commissioner, 251 F.2d 278 (7th Cir.), *cert. denied*, 356 U.S. 958 (1958).

[15] 89 S. Ct. at 502.

[16] *Id.*

to the jury implied that the proscribed motive had to be the sole determining factor in the decision to accumulate.[17] On remand the court instructed that the correct test was that tax avoidance must be the "dominant, controlling, or impelling" motive.[18]

On certiorari to the Supreme Court, the major argument of the parties dealt with the construction of the words "formed or availed of for the purpose of tax avoidance" in section 532(a). Taxpayer argued that the use of the word "the" instead of "a" supported the "dominant purpose" test applied by the court of appeals.[19] The government asserted that the phrase, when read as a whole, supported its proposed "any purpose" test.[20] Discounting both arguments as inconclusive and referring to the statutory language as "inherently vague,"[21] the Court concentrated on the factor of congressional intent to find support for the government's position. In examining the history of the accumulated earnings tax, the Court noted that Congress had consistently maintained a firm position against this type of tax avoidance.[22] The Court interpreted the 1954 additions[23] to the accumulated earnings tax provisions as congressional recognition of "the tremendous difficulty of ascertaining the purpose for corporate accumulations"[24] and concluded that the "congressional response to these facts has been to emphasize unreasonable accumulation as the most significant factor in the incidence of the tax."[25] Since Congress intended to emphasize the relatively objective inquiry into the reasonableness of the accumulation, reasoned the Court, it would be inconsistent with this intent to allow a taxpayer, once the objective criterion is satisfied, to escape the tax when the proscribed purpose was present to any degree.[26] Thus, the Court concluded that Congress intended to impose the surtax if any tax avoidance motive is present when there is an accumulation beyond the reasonable needs of the business.

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[17] Donruss Co. v. United States, 384 F.2d 292, 298 (6th Cir. 1967).

[18] *Id.*

[19] 89 S. Ct. at 504. See Young Mtr. Co. v. Commissioner, 281 F.2d 488 (1st Cir. 1960).

[20] 89 S. Ct. at 504.

[21] *Id.*

[22] *Id.* at 505-07.

[23] Section 535(c) allows a minimum credit of 100,000 dollars to the corporation. INT. REV. CODE of 1954, § 535(c). Section 537 provides that the term "reasonable needs of the business" shall include the "reasonably anticipated needs of the business." INT. REV. CODE of 1954, § 537.

[24] 89 S. Ct. at 507.

[25] *Id.*

[26] *Id.*

Mr. Justice Harlan, concurring in part and dissenting in part, agreed that the congressional intent was to rely more heavily on the objective test.[27] He concluded, however, that the words of section 533(a) reveal an intention to give the taxpayer a "last clear chance" to prove the absence of the avoidance motive. Mr. Justice Harlan took issue with the majority's instruction on remand, which he felt would "effectively deny to the taxpayer the 'last clear chance' which Congress clearly meant to afford and substitute a very fuzzy chance indeed."[28] While arguing that the "any purpose" test of the majority might in reality make the jury believe it must impose the tax whenever it finds the accumulation unreasonable,[29] Harlan agreed that the "dominant, controlling, or impelling" motive test is also inappropriate since it would apparently require proof that tax avoidance was the strongest of all purposes.[30] Instead, he reasoned, the jury should be instructed "to impose the tax if it finds that the taxpayer would not have accumulated earnings but for its knowledge that a tax saving would result."[31] It is arguable that this proposed "but for" test is the same as the "dominant purpose" standard since if taxpayer would not have accumulated earnings but for the tax factor, then the tax factor must have been the "dominant purpose." In light of his specific rejection of the "dominant purpose" test, however, it would seem that Justice Harlan intends his "but for" test to be analogous to the "determinating purpose" test. Under this standard the jury must find that tax avoidance was one of the principle reasons for the accumulation, though it need not be the "dominant, controlling, or impelling" motive.[32]

It is questionable whether the test of the majority carries out the true intentions of Congress. While there is little doubt that the 1954 additions[33] to the tax provisions place more emphasis on the reasonableness of corporate accumulation, it is important to note that both new provisions are designed to alleviate the burden on the taxpayer.[34] Indeed, as the Court itself concluded, the amendments were a congressional recognition of "the tremendous difficulty of ascertaining the purpose for corporate accumulations."[35] It would appear to be inconsistent with this con-

[27] *Id.* at 508-10.
[28] *Id.* at 508.
[29] *Id.* at 509.
[30] *Id.* at 510.
[31] *Id.*
[32] See note 13 *supra.*
[33] See note 23 *supra.*
[34] See S. REP. No. 1622, 83d Cong., 2d Sess. (1954).
[35] 89 S. Ct. at 507.

gressional attitude to require imposition of the tax where the jury, judging in retrospect,[36] finds the business reasons for accumulation without merit but further finds only some slight avoidance motive.[37] The argument for a less strict congressional intent gains further support from the fact that the 1954 recodification of section 533(a) deleted the adjective "clear" from the phrase "clear preponderance of the evidence"—the burden that the taxpayer must meet to show insufficient tax avoidance motive. While it may have been a mere change in phraseology, logically the deletion indicates an intent to reduce the taxpayer's burden of proof.

In answer to the Harlan criticism that the "any purpose" test effectively denies the taxpayer a "last clear chance" to escape the tax,[38] the majority pointed out that the taxpayer may "show that even though knowledge of the tax consequences was present, that knowledge did not contribute to the decision to accumulate earnings."[39] This chance, however, is quite slim. As one writer has argued: "Since the issue of whether to pay a dividend involves a balancing of the needs of the corporation and the desires of the stockholders for a cash return on their investment, the potential taxes on such dividends would necessarily play some part in a decision to have the corporation accumulate its earnings . . . ."[40] Thus, corporate knowledge of the tax consequences normally does influence the decision to accumulate, and, of course, there is always a chance that the accumulation might be found to be unreasonable. It has been suggested that "the only corporations that could safely accumulate income would be those having stockholders with substantial net losses,"[41] thus having little interest in dividend tax consequences. It is doubtful that Congress intended such a result.

Perhaps the sounder view is the "determinating purposes" test promulgated in *Kerr-Cochran, Inc. v. Commissioner*[42] and ostensibly

[36] Although the rule is that the reasonableness is to be judged as of the time of the accumulation, normally several years have elapsed between the decision to accumulate and the trial, and subsequent events realistically do influence the jury's determination. See Smoot Sand & Gravel Corp. v. Commissioner, 241 F.2d 197 (4th Cir. 1957).

[37] See Note, *Federal Income Taxation—Accumulated Earnings Tax—Tax Avoidance Must Be the Dominant Purpose For the Accumulation of Earnings and Profits By a Corporation Before the Accumulated Earnings Tax May Be Imposed*, 43 NOTRE DAME LAW. 566 (1968).

[38] 89 S. Ct. at 508.

[39] *Id.*

[40] Herwitz, *supra* note 9, at 875.

[41] Young Mtr. Co. v. Commissioner, 281 F.2d 488, 491 (1st Cir. 1960).

[42] 253 F.2d 121 (8th Cir. 1958).

adopted in Mr. Justice Harlan's "but for" test. As noted above this test would require a jury finding that tax avoidance was a major consideration in the decision to accumulate before imposing the surtax. This would require more than the mere existence of an avoidance factor but less than a conclusion that the proscribed purpose was the "dominant, controlling, or compelling" motive. Arguably this would be consistent with the burden of proof as set forth in section 533(a) since the test, while placing emphasis on the unreasonable accumulation, would give the taxpayer a realistic "last clear chance" to escape the tax. Clearly Congress intended such a result since the statute provides that even though the objective criterion of unreasonableness be satisfied, the taxpayer can avoid imposition of the surtax by proving by a "preponderance" of the evidence the absence of the proscribed purpose.

It is interesting to speculate as to the actual impact of the "any purpose" test. Keeping in mind the fact that any test of taxpayer motive is subjective in nature, it would seem reasonable to expect an average jury to engage in a "balancing of the equities." For example, if the jury, after making the basically objective determination that the accumulation was unreasonable, found that on a scale of ten motivation factors only one of the factors was tax avoidance, it might well render its verdict that no tax avoidance purpose was present. Indeed one might argue that the average jury is invited to engage in a balancing practice under the "any purpose" instruction, thus finding no tax avoidance purpose where it might otherwise have found a slight avoidance purpose present. Since the existence of the tax avoidance purpose is a factual determination, appellate courts might be hard pressed to find grounds for overturning such verdicts.

While in reality the average jury might engage in a balancing practice, corporate planners must anticipate a literal interpretation of the "any purpose" instruction. The effect,[43] then, of the *Donruss* decision may be far-reaching, especially in areas such as corporate diversification.[44] Since the Court's instruction is based upon a questionable interpretation of

[43] The effect of the decision will fall primarily on closely held corporations. As one writer pointed out, "although there is nothing in the Code of Regulations so stating, publicly held corporations can be said not to fall within the scope of the accumulated earnings tax." Note, *The Accumulated Earnings Tax as a Deterrent to Business Diversification of Close Corporations*, 16 U. KAN. L. REV. 98, 103 (1967).

[44] For discussion of the problems presented corporations by the accumulated earnings tax see *Id.*; Note, *The Accumulated Earnings Tax and the Problem of Diversification*, 64 MICH. L. REV. 1135 (1966).

congressional intent, it is submitted that Congress should act to restate the amount of avoidance motive it feels should be present before imposition of the surtax.

JAMES R. CARPENTER

Income Tax—Deductibility of Losses Suffered in Intra-Family Transfers

In *Merritt v. Commissioner*,[1] the Court of Appeals for the Fifth Circuit held that section 267 of the Internal Revenue Code of 1954 precluded deduction of a loss suffered by a husband when his stock in a family corporation was sold to his wife in an involuntary sale. The sale had been forced by the Internal Revenue Service to obtain funds for the payment of taxes from previous years, and the wife's 25,000 dollar bid was in sharp contrast to the 135,000 dollar basis at which the husband had been carrying the property. But the court of appeals affirmed the decision of the Tax Court[2] and disallowed the 110,000 dollar deduction.

The broad terms of section 267 disallow any deduction claimed for losses suffered in transactions between certain related taxpayers, generally family members.[3] The provisions of this present section originated in section 24(a)(6)(A) and (B) of the Revenue Act of 1934.[4] Prior to 1934, the rule was that the deductibilty of all sales, regardless of the identity of the vendor and vendee, depended on the presence of a bona

[1] 400 F.2d 417 (5th Cir. 1968).
[2] James H. Merritt, Sr., 47 T.C. 519 (1967).
[3] Section 267 provides:
(a) Deductions Disallowed.—No deduction shall be allowed—
(1) Losses.—In respect of loses from sales or exchanges of property (other than losses in cases of distributions in corporate liquidations), directly or *indirectly*, between persons specified within any one of the paragraphs of subsection (b).
. . . .
(b) Relationships.—The persons referred to in subsection (a) are:
(1) Members of a family, as defined in subsection (c)(4)
. . . .
(c) Constructive Ownership of Stock—For purposes of determining, in applying subsection (b), the ownership of stock—
. . . .
(4) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants. . . .
INT. REV. CODE of 1954, § 267 (emphasis added).
[4] 48 Stat. 680, 691 (1934).

fide sale as evidenced by the seller's divesting himself of title or control.[5] Allegations that a sale was a bona fide one in cases involving transactions between related taxpayers were often difficult to overcome,[6] and section 24(a) was enacted to counter widespread use of these transfers as a means of tax avoidance.[7] Its provisions were held not applicable to bona fide transfers.[8]

This history led the Supreme Court to conclude in the classic case of *McWilliams v. Commissioner*,[9] relied on in *Merritt*, that section 267 precluded deduction of losses suffered by a taxpayer from sales of stock *on the open market* when the same number of shares were purchased by the same broker for the taxpayer's wife, and of losses suffered by the wife when the process was reversed.[10] The Court stated:

> The difficulty of determining the finality of an intrafamily transfer was one with which the courts wrestled under the pre-1934 law, and which Congress undoubtedly meant to overcome by enacting the provisions of § 24(b) [now § 267].
>
> It is clear, however, that this difficulty is one which arises out of the close relationship of the parties, and would be met whenever, by *prearrangement*, one spouse sells and another buys the same property at a common price, regardless of the mechanics of the transaction. . . .
>
> . . . .
>
> Moreover, we think the evidentiary problem was not the only one which Congress intended to meet. Section 24(b) states an absolute prohibition—not a presumption—against the allowance of losses on any sales between the members of certain designated groups. The one common characteristic of these groups is that their members, although distinct legal entities, generally have a near-identity of economic in-

[5] Criteria of "good faith" are discussed in John E. Zimmermann, 36 B.T.A. 279, 284-86 (1937). *See also* Note, *Nondeductible Capital Losses and Bona Fide Sales under the Federal Income Tax*, 49 YALE L.J. 75 (1939).

[6] *See, e.g.*, Cole v. Helburn, 4 F. Supp. 230 (W.D. Ky. 1933).

[7] H.R. REP. No. 704, 73d Cong., 2d Sess. 23 (1934); S. REP. No. 588, 73d Cong., 2d Sess. 27 (1934). The bona fide sale standard still applies to transfers not covered by § 267. Treas. Reg. § 1.267(a)-1(c) (1958). *See* Jesse Johnson, 24 T.C. 107 (1955), *aff'd*, 233 F.2d 752 (4th Cir.), *cert. denied*, 352 U.S. 841 (1956); Mintz, *Tax Disallowance of Loss on Sales between Related Companies or Individuals*, 4 MIAMI L.Q. 277, 294-300 (1950).

[8] Frank C. Engelhart, 30 T.C. 1013 (1958); Nathan Blum, 5 T.C. 702 (1945); W.A. Drake, Inc., 3 T.C. 33, *aff'd*, 145 F.2d 365 (10th Cir. 1944). *See also* Treas. Reg. § 1.267(a)-1(c) (1958).

[9] 331 U.S. 694 (1947).

[10] *See also* Robert Boehm, 28 T.C. 407 (1957), *aff'd per curiam*, 255 F.2d 684 (2d Cir. 1958), where taxpayer's loss was disallowed when third parties who bought his securities shortly thereafter sold them to a corporation he controlled. *Cf.* Charles E. Cooney, P-H Tax. Ct. Mem. ¶ 42,589 (1942).

> terests. It is a fair inference that even legally genuine intra-group transfers were not thought to result, usually, in economically genuine realizations of loss, and accordingly that Congress did not deem them to be appropriate occasions for the allowance of deductions.[11]

Inferior courts, in applying section 267 and *McWilliams* to varied factual situations involving involuntary transfers, have reached different, and seemingly inconsistent, results. Courts have rationalized these results by stressing certain factors such as the lack of exceptions to the statute, the taxpayer's ability (or lack of it) to determine the time of transfer, the formalities of title, and the facts surrounding the judicial sale.

For instance, the Tax Court in *Thomas Zacek*[12] looked to the literal language of the statute. The case involved a sheriff's sale of real property. The purchasers, who were also the foreclosing mortgagees, had been cotenants of the parties (their brothers and sisters) claiming the deduction. The sale price covered only the mortgage, principal, interest, back taxes, and costs. Although these facts indicated that the sale was in good faith, the court reasoned that "the language chosen by Congress is so broad that it includes bona fide transactions, without regard to hardship in particular cases,"[13] and disallowed any deduction for the loss.

In *McCarty v. Cripe*,[14] however, the Seventh Circuit concluded that an involuntary sale was not one between persons or groups designated by section 267. The case involved a foreclosure sale of real property to satisfy liens for taxes and assessments for public improvements at a loss of 19,000 dollars. The property was bought after "spirited bidding" by a trustee for a corporation. But the former owner of the land owned over fifty per cent of the corporation's stock, and hence the sale was arguably covered by section 267(b)(2). Nevertheless, the court held that a tax title had nothing to do with any previous title, and rejected an argument that *McWilliams* looks to identity of economic interest. It concluded that the purpose of that decision was to "put an end to the right of *taxpayers to choose*, by intra-family transfers . . . *their own time* for realizing tax losses on investments which, for most practical purposes, are continued uninterrupted."[15]

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[11] 331 U.S. at 698-99 (emphasis added).

[12] 8 T.C. 1056 (1947).

[13] *Id.* at 1057.

[14] 201 F.2d 679 (7th Cir. 1953).

[15] *Id.* at 682, *quoting McWilliams v. Commissioner*, 331 U.S. 694, 700 (1947). The next paragraph of the latter decision, however, begins: "We are clear as to this purpose, too, that its effectuation obviously had to be made independent of the manner in which an intra-group transfer was accomplished." 331 U.S. at 700.

The Fourth Circuit's decision in *McNeill v. Commissioner*,[16] emphasized the taxpayer's lack of control over the authorities' disposition of his property. The case is even more difficult to distinguish from *Merritt*. Real estate, purchased by McNeill for 20,000 dollars, had been seized by county commissioners for taxes due, but when they were unable to find a purchaser, they offered to resell to McNeill for 750 dollars. McNeill arranged a purchase by Royal Village Corporation, which was owned by him and his family. The court reasoned that the 19,250 dollar loss was brought about not by the transfer to Royal Village, but by the seizure and sale two and one-half years earlier. "[T]he true nature of the transfer rather than the form" was controlling, and nothing was found to "warrant the inference that McNeill controlled the . . . authorities so that in effect the seizure and sale for taxes were his actions and not theirs. . . ."[17]

The Fifth Circuit in *Merritt* took issue with *McCarty* and *McNeill*. It challenged their assertion that any break in the string of ownership occurring when the taxing authority seizes the property has significance.[18] The court pointed out that the Supreme Court in *McWilliams* had faced a situation where title had passed through an intermediate party (in fact, the identical property had not been the subject of both the sale and repurchase) and had looked to substance showing the same economic interest had been retained. The court in *Merritt* also stated that while preventing taxpayers from choosing their own time to realize a benefit might have been one of Congress' goals, that alone could not explain the broad sweep of the statute. The court emphasized that continuity of control and identity of interest were the controlling factors under *McWilliams*.

Stock, especially stock in a close corporation as in *Merritt*, is particularly likely to be the subject of the kind of transaction that inspired section 267. It is less attractive to outside bidders and more amenable to family control, and its purchase by prearrangement at a judicial sale more likely. The statute, however, says nothing to justify treating stock any differently from other types of property. While the presence of "spirited bidding" arguably indicates good faith, or at least

[16] 251 F.2d 863 (4th Cir.), *cert. denied*, 358 U.S. 825 (1958).

[17] *Id.* at 865-66.

[18] 400 F.2d at 420. *But see* United States v. Norton, 250 F.2d 902 (5th Cir. 1958), *aff'g in part and rev'g in part*, 144 F. Supp. 425 (W.D. La. 1956) (sale of stock by the son and an identical purchase by the mother twenty-eight days later, held, the passage of time signified a complete break in control, making it impossible that the sale was *between* son and mother).

a lack of collusion between seller and purchaser, it is difficult to see its relevance to a statute that purports to reject the good faith standard. Because such distinctions seem meaningless or inappropriate it is hard to avoid the conclusion, which the *Merritt* court reached, that *Merritt* is irreconcilable with *McNeill,* and probably *McCarty.*

The Fifth Circuit's refusal to treat *involuntary* sales differently from voluntary sales under section 267 can have a drastic affect on the tax liability of taxpayers in the Merritt situation. An important question will arise if Mrs. Merritt at some future time sells her stock to an outsider. In that case her sale, unlike her husband's, would mark the loss with finality. Since her bid was 25,000 dollars, however, that would presumably be her basis for tax purposes unless the same statute that denied her husband his loss makes some provision for her. Section 267(d) of the Code only provides:

> (d) AMOUNT OF GAIN WHERE LOSS PREVIOUSLY DISALLOWED—IF—
> (1) in the case of a sale or exchange of property to the taxpayer a loss sustained by the transferor is not allowable to the transferor as a deduction by reason of subsection (a)(1) . . . then such gain shall be recognized only to the extent that it exceeds so much of such loss as is properly allocable to the property sold or otherwise disposed of by the taxpayer. . . .[19]

Hence, if the wife is able to obtain more than 135,000 dollars for the stock, only the excess over 135,000 dollars will be taxable. What will be the situation if the price she is able to obtain is between 25,000 dollars and 135,000 dollars? It might be argued that a transfer between persons having "an identity of economic interests" is no transfer at all in the eyes of the taxing authority, and thus her basis should be 135,000 dollars. The Senate report on the bill,[20] the Income Tax Regulations,[21] and commentators' opinions,[22] however, reject this view.[23] Therefore, if the second

[19] INT. REV. CODE of 1954, § 267(d).

[20] Any gain to the taxpayer on the disposition of the property will be recognized only to the extent that it exceeds the amount of the loss not previously allowable. This rule does not affect the basis of the property for determining gain, and consequently depreciation and other items which depend upon that basis are also unaffected.
S. REP. No. 1662, 83d Cong., 1st Sess. 27 (1954).

[21] Treas. Reg. § 1.267-1(c)1 (1958).

[22] Hertz, *Dealing with Related Persons: Salaries and Other Compensation; Sales of Property; Interest Accruals and Other Deductions,* N.Y.U. INST. ON FED. TAX. 577, 602 (1963); Holman, *Basis Problems in Connection with Family Held Property,* 13th N.Y.U. INST. ON FED. TAX. 1203, 1212 (1954); Kutz, *Transactions Between Related Taxpayers,* 13th N.Y.U. INST. ON FED. TAX. 69, 77 (1954).

[23] Herberich, Hall, Harter Agency, P-H Tax Ct. Mem. ¶ 44,146 (1944), held

sale is for 50,000 dollars, for example, the husband-wife "unit" has been deprived of 85,000 dollars (the original purchase price of 135,000 dollars minus the ultimate sale price of 50,000 dollars) in tax deductions merely because an intra-family transfer occurred, which was not only involuntary but, worse, forced by the Internal Revenue Service.[24] If the second sale is for less than 25,000 dollars, 10,000 dollars for example, the wife's deduction apparently will be 15,000 dollars, the difference between the 25,000 dollars and the sale price.[25]

Such a result is harsh when section 267 is applied to voluntary transfers, but when, as in *Merritt*, the rule is extended to those who were forced to part with their property, its application is severe indeed. There is little evidence that involuntary sales of any nature where in the contemplation of Congress when section 267(a)'s predecessors were being considered. However, there is also little evidence that Congress intended them to be excluded. Section 267(d) apparently was intended to keep the purchasing party's basis at the purchase figure, and again, apparently, no separate consideration was given to the forced sale situation. The question is obviously a difficult one. If the formal passing of title or the removal from taxpayer control is relied on to give relief in the forced sale context, taxpayers may be able to avoid taxes by making intra-family transfers through a third party. It is difficult, moreover, to determine just how far the ruling in *McWilliams* is binding on the lower courts in the related *Merritt* situation, or even how it applies.

It has been suggested that section 267 be amended to create a mere presumption of continued control, with the possibility of the taxpayer's proving good faith left open. It has been further recommended that a taxpayer be allowed to establish a "potential loss" after a section 267 transaction, based on the difference between the transferor's adjusted basis and the section 267 transfer price or the fair market value, whichever is smaller. This "potential loss" would be deductible if the property thereafter passes out of his sphere of economic control.[26]

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that parties could not rescind a transaction that fell within § 267 and thereby restore the old basis.

[24] In *McWilliams* it was said: "[i]t is a fair inference . . . that Congress did not deem . . . [legally genuine intra-family transfers] to be appropriate occasions for the allowance of deductions." 331 U.S. at 699. If so, would not the transfer of the property out of the "unit" be a proper "occasion" for the allowance of the entire deduction?

[25] Treas. Reg. § 1.267(d)-1(a)(4), Example 2 (1958).

[26] See Comment, *Some Effects of Nonrecognized Losses on Corporations and Their Shareholders*, 35 N.C.L. REV. 31, 59-61 (1956).

The question of substituting a presumption for section 267's prohibition is not one for the courts. The fact that Congress has enacted 267(d) seems to imply that no other relief should be granted to intra-family transferors, especially if such transfer is willful. When a transfer within the economic "unit" has been *forced*, however, the equities of the situation, especially in the absence of a specific Congressional pronouncement, would suggest retention by that "unit" of the original basis.

STEPHEN MASON THOMAS

Labor Law—The Legality of Co-ordinated Bargaining

Co-ordinated or coalition bargaining is a new technique in the power struggle between labor and management. This approach to collective bargaining consists of forming a multi-union negotiating committee for the purpose of cooperation and communication among several unions that represent employees of a common employer. Through this process the cooperating unions hope to achieve common contract terms.[1] Management has not welcomed this union practice. When co-ordinated union bargaining extends to the bargaining table, resistance by management has taken the form of refusing to negotiate wth joint-union committees.

The legality of union insistence on management's negotiating with a union coalition was considered by the National Labor Relations Board in *General Electric Co.*[2] In that case the union whose contract was to be negotiated insisted on including members of other unions on its negotiating committee. The Board held that by refusing to bargain with this committee, General Electric was guilty of unfair labor practices.

Eight of the unions[3] with which G.E. had contracts were dissatisfied with a lack of progress in previous negotiations with that company and therefore formed the Committee on Collective Bargaining (CCB).[4] The objective of the CCB was to gain the cooperation in collective bargaining of unions representing employees of a single employer in order to negotiate major economic items on a company-wide, national level. G.E.'s labor

[1] *See* Hilderbrand, *Coordinated Bargaining, An Economist's View*, 19 LAB. L.J. 524 (1968).

[2] 173 N.L.R.B. No. 46, 69 L.R.R.M. 1305 (Oct. 25, 1968).

[3] These eight unions became dissatisfied with the lack of union progress under G.E.'s purported "whipsawing" tactics. Under this practice G.E. convinced the weaker unions to accept its contract offers and then used the acceptances to bring pressure on the stronger unions.

[4] 69 L.R.R.M. at 1305.

contract with the International Union of Electrical Workers (IUE), a member of the CCB, was about to expire. G.E.'s representatives walked out of preliminary negotiations before bargaining could begin when they discovered that IUE's committee included members of the other seven unions constituting the CCB. The company persisted in its refusal to meet with this multi-union commitee beyond the bargaining date specified by the labor contract.[5] IUE filed unfair labor practice charges against G.E., alleging violation of sections 8(a)(5)[6] and 8(a)(1)[7] of the National Labor Relations Act.[8]

In its argument to the Board, G.E. contended that it had no duty to bargain with these other unions because their contracts had not expired and because their presence prevented good faith bargaining. IUE asserted, on the other hand, that the committee's only purpose at that time was to negotiate a contract for IUE. The Board said that it was crucial to its analysis of the case that G.E. had refused to bargain even before negotiations were to begin. As a result of this refusal, the Board held that it was not required to determine whether IUE's assertion was in fact true.[9] Absent proof of an agreement between these unions that would bind the IUE to accept only those contract terms approved by the CCB,[10] G.E. had a duty to bargain with the IUE's multi-union bargaining committee. Therefore, the mere presence of the non-IUE union committee members did not justify G.E.'s walk-out and refusal to bargain. The Board expressly limited the application of its decision by its focus on the pre-negotiation walk-out and the lack of proof of a conspiratorial union agreement by which IUE could accept only CCB-approved terms. The impact of the holding, however, may in subsequent cases extend

[5] Also at issue was whether G.E. was guilty of unfair labor practices for refusing to bargain before the bargaining date set by the labor contract. That question, however, will not be dealt with here since G.E.'s refusal continued beyond the contractually required bargaining date.

[6] It shall be an unfair labor practice for an employer to refuse to bargain collectively with the representatives of his employees. . . .

National Labor Relations Act § 8(a)(5), 29 U.S.C. § 158(a)(5) (1964).

[7] It shall be an unfair labor practice for an employer to interfere with, restrain, or coerce employees in the exercise of the right guaranteed by section 7.

National Labor Relations Act § 8(a)(1), 29 U.S.C. § 158(a)(1) (1964).

[8] A district court enjoined G.E.'s refusal to bargain. McLeod v. General Elect. Co., 257 F. Supp. 690 (S.D.N.Y.), *rev'd*, 366 F.2d 847 (2d Cir. 1966), *rev'd*, 385 U.S. 533 (1967). The issues raised in this collateral case are not pertinent to the problem of the legality of co-ordinated bargaining.

[9] 69 L.R.R.M. at 1306-07.

[10] 69 L.R.R.M. at 1311.

beyond those limits to allow use of coalition bargaining committees in all situations, because the unions need never enter into any such binding conspiratorial agreement in order to carry out their co-ordinated plan. G.E. was aware of this implication and insisted that the mere presence of members of other unions on IUE's committee justified its refusal to bargain. Viewed in light of these considerations, the decision represents a further development in the use of co-ordinated bargaining. This extension, however, raises serious questions that are certain to be considered by the courts.

The development of co-ordinated bargaining has resulted in a conflict of valid policies, each with a statutory foundation. Section 7[11] of the Act guarantees employees the right to select their own bargaining representatives. This in turn involves the correlative right of that representative to choose the members of its negotiating committee. This right, however, has been construed not to be absolute. It has assumed a subordinate role whenever it has produced a situation that might violate section 8(d)[12] of the Act. This section, as does the entire Act generally, requires the parties to refrain from conduct destroying the atmosphere conducive to good faith bargaining. When a company is to bargain with an individual union, as it is required to do, the presence of members of other unions with which the company has contracts may have an adverse effect on the collective bargaining atmosphere. The employer may resent the presence of "outsiders" from unions whose contracts have not yet expired. It may in fact result in the company bargaining with a union when it is not required to do so. The co-ordinated bargaining committee, although properly selected by the union, may therefore present an impediment to good-faith bargaining.

The majority opinion in *General Electric Co.* recognized that the rights of a union to select its bargaining representatives are not absolute, but limited the exceptions to those rights to "unusual situations where the chosen representative is so tainted with conflict or so patently obnox-

[11] Employees shall have the right to self-organization . . . 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. . . .

National Labor Relations Act § 7, 29 U.S.C. § 157 (1964).

[12] [T]o bargain collectively is the performance of the mutual obligation of the employer and the representative of the employees to meet at reasonable times and confer in good faith with respect to wages, hours, and other terms and conditions of employment, or the negotiation of an agreement. . . .

National Labor Relations Act § 8(d), 29 U.S.C. § 158(d) (1964).

ious as to negate the effect of good-faith bargaining."[13] In reaching its decision that no unusual circumstances existed in *General Electric Co.*, the Board relied on two recent decisions.

In *Standard Oil Co. v. NLRB*,[14] the union's bargaining committee included employees who were members of different locals, but were still within the same international union of which the negotiating union was a member. The company believed that this technique was an attempt to bring about company-wide bargaining, and therefore refused to bargain with this committee. The court affirmed the Board's holding that the company's refusal to bargain was unjustified. This decision is distinguishable on its facts from the *General Electric* case. In *Standard Oil*, there were several locals of one international union; whereas in *General Electric* there were seven other different internationals represented on IUE's committee.

The facts of *American Radiator & Standard Sanitary Corp. v. NLRB*[15] are more directly in point with *General Electric*. The Board had ruled that the employer was required to bargain with the union's committee that included members of other unions.[16] The court denied enforcement noting that the allegedly unfair employer practice was the mere writing of a letter suggesting the parties continue to bargain, pending the Board's determination, without the presence of the outsiders. The company then acquiesced to the union's counter-offer for the company to continue to bargain under protest. The court concluded that this conduct did not add up to a refusal to bargain.[17] Since the court did not decide the issue involved in *General Electric*, the decision is hardly a strong precedent for the Board's decision in *General Electric*.

The Board's exceptions to the right to select one's own representative have been limited to "unusual situations," and it failed to see anything unusual in *General Electric*. There have been only a few cases finding such a situation as the Board has previously shown a reluctance to give effect to that limitation. In several cases, in order to overcome this reluctance, the courts have reversed the Board's determinations. In each case the courts recognized the right to select one's own bargaining representative. That right was subordinated, however, as threatening the required good faith atmosphere.

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[13] 69 L.R.R.M. at 1307.
[14] 322 F.2d 40 (6th Cir. 1963).
[15] 381 F.2d 632 (6th Cir. 1967).
[16] 155 N.L.R.B. 736 (1965).
[17] 381 F.2d at 635.

In *NLRB v. Kentucky Utilities Co.*,[18] the company refused to bargain with a union's representative who was a former company employee. The representative in question had been discharged by the company but then ordered reinstated with back pay by the Board in a prior proceeding. He declined reinstatement, however, and obtained employment as an international representative of his local's international union. The Board also had held in a former case that certain testimony given by this representative against the company was untrue. He had, in addition, expressed his purpose to destroy this company financially.[19] The Board in *Kentucky Utilities*[20] held that the company's refusal to negotiate constituted a violation of the right of a selected bargaining representative to choose the individual members of its committee.[21] The court of appeals reversed the Board and emphasized that the policy of the National Labor Relations Act was to insure an atmosphere of good faith for collective bargaining. This policy, it was held, would be of no value if the company were required to bargain with this particular union negotiator. The Board's decision was modified accordingly.

A former union negotiator was the company's bargaining representative in *NLRB v. International Ladies' Garment Workers' Union*.[22] This representative had held highly confidential positions in representing the union with whom he was now employed to negotiate. The time of this change of employment was in fact close to the date on which bargaining was to begin. An official of the company had tauntingly indicated to the union that they had " 'put one over on the union' " and had " 'the union on the spot.' "[23] The Board held that the union's refusal to bargain was not justified in this situation.[24] Here again the court of appeals, though recognizing the rights of each party to choose its representative, refused to find these rights "absolute or immutable."[25] In denying enforcement, the court concluded that any negotiations under these circumstances would be in form only, without good faith.

In *Bausch & Lomb Optical Co.*,[26] the board held that a union that is also a business rival of an employer is not a proper bargaining repre-

[18] 182 F.2d 810 (6th Cir. 1950).
[19] *Id.* at 812.
[20] 76 N.L.R.B. 845 (1948).
[21] *See In re* Oliver Corp., 74 N.L.R.B. 483 (1947).
[22] 274 F.2d 376 (3d Cir. 1960).
[23] *Id.* at 379.
[24] 122 N.L.R.B. 1390 (1959).
[25] 274 F.2d at 378.
[26] 108 N.L.R.B. 1555 (1954).

sentative of that company's employees. The Board stated that the mere fact that the anticipated conflicts had not yet been realized was not controlling. The latent danger was sufficient. To require the employer to meet with this union would result in bargaining in which "at best, intensified distrust of the Union's motives would be engendered."[27]

In the more recent case of *NLRB v. David Buttrick Co.*,[28] the employer refused to meet with a local union on the ground that a loan arrangement by the local's international with the employer's competitor had raised a serious conflict of interests. The Board concluded that there was insufficient evidence of connection between the local and the loan, and held unlawful the employer's refusal to bargain.[29] The court of appeals stated that although employees have the right to be represented by persons of their own choosing, "there is the correlative duty of complete loyalty of such representatives to their constituents."[30] In remanding the case the court indicated that the Board should not be concerned with the local's autonomy or with its connection with the loan, but rather with an assessment of the potential, not merely actual, conflict of interest.

The principle to be gained from these cases is that whenever a chosen representative has an unusually hostile interest in the negotiations, or an independent concern therein that may result in a conflict of interest, exception may be taken if his presence threatens to disrupt good faith bargaining. In applying this principle to the *General Electric* case, the dissent stated:

> While . . . those who represent other units may claim and honestly intend to devote their particular skills solely to bargaining in behalf of the employees currently under consideration, it is virtually impossible for them to separate their own ultimate goals and problems from those of the unit for which they are currently bargaining.[31]

A final question is the effect of co-ordinated bargaining upon the individual bargaining units. Section 9[32] of the Act provides that the bargaining unit will be that unit certified by the Board. The employer is bound to bargain only with the duly elected representative of that certified unit. The Board and the courts have long held that it is a violation of

[27] *Id.* at 1561.
[28] 361 F.2d 300 (1st Cir. 1966).
[29] 154 N.L.R.B. 1468 (1965).
[30] 361 F.2d at 305.
[31] 69 L.R.R.M. at 1312.
[32] 29 U.S.C. § 159 (1964).

a union's duty to bargain to insist upon an expansion or change in the certified unit that it represents.[33] This policy was expressed in *Kennecott Copper Corp.*,[34] where the Board held that two separate units could not be merged for bargaining,[35] absent an election by the employees approving such action. As stated by the dissent in *General Electric*:

> [T]o allow representatives of other units to attend and participate in negotiations for a unit which they do not represent may have the effect of broadening or narrowing, at the pleasure of the unions concerned, the numbers, types, and locations of the employees covered or affected by the bargaining. This in turn would conflict with the responsibility of the Board to determine the scope of the appropriate unit under Section 9 of the Act, and would curtail the Board's power to enforce the good faith bargaining requirement of Sections 8(a)(5) and 8(b)(3).[36]

In addition to these legal questions, the practical reasons for the union's insistence upon this new bargaining technique must be examined.[37] Co-ordinated bargaining has had its greatest appeal where labor has felt frustrated by the traditional individual union-management negotiations.[38] One of the reasons this technique was instituted by the unions has been the numerous conglomerate mergers that have weakened the union's position relative to management in collective bargaining.[39] As a result of this inequality of bargaining power, the unions found that they could increase their power by working together and maintaining a high level of inter-union communication. Through this process the unions have realized that to bargain effectively, they must bargain for common con-

[33] *See, e.g.*, Douds v. International Longshoremen's Ass'n, 241 F.2d 278 (2d Cir. 1957); Smith Steel Workers, 174 N.L.R.B. No. 41 (1969); Hod Carriers, Local 345, 144 N.L.R.B. 978 (1963); Painters Union, 126 N.L.R.B. 997 (1960), *enforced*, 293 F.2d 133 (D.C. Cir.), *cert. denied*, 368 U.S. 824 (1961); International Longshoremen's Ass'n (Chicago Stevedoring), 125 N.L.R.B. 61 (1959), *modified and enforced*, 286 F.2d 661 (7th Cir.), *cert. denied*, 368 U.S. 820 (1961); NLRB v. Texlite, Inc., 119 N.L.R.B. 1792 (1958), *enforced sub nom.* NLRB v. International Bd. of Elec. Workers, 266 F.2d 349 (5th Cir. 1958).

[34] 98 N.L.R.B. 75 (1952).

[35] *See also* UMW v. Pennington, 381 U.S. 657 (1965); United States Pipe & Foundry Co. v. NLRB, 298 F.2d 873 (5th Cir. 1962).

[36] 69 L.R.R.M. at 1312. The majority did not think it necessary to discuss this issue.

[37] See Freidin, *New Collective Bargaining*, 50 VA. L. REV. 1034 (1964); Lasser, *Coordinated Bargaining, A Union Point of View*, 19 LAB. L.J. 512 (1968).

[38] Lasser, *Coordinated Bargaining, A Union Point of View*, 19 LAB. L.J. 512 (1968).

[39] Hilderbrand, *Coordinated Bargaining, An Economist's View*, 19 LAB. L.J. 524 (1968).

tract terms.[40] These union practices are not be condemned; they may in fact be quite necessary. The legal implications of this practice, however, may lead the courts to conclude that it presents too great a threat to good faith bargaining and to the certified bargaining units to be sustained.

Union insistence upon employer acceptance of a coalition bargaining committee therefore is not always protected by section 7 of the Act contrary to the Board's implication in *General Electric*. The detrimental effect of this practice on the requirement of good faith bargaining may have justified the employer's refusal to negotiate with that committee. This conclusion, however, does not preclude the employer's consent to the union's including "outsiders" on its committee. The propriety of such consent has been recognized by the courts;[41] co-ordinated bargaining is not illegal per se. Its use, however, should properly be limited to those situations involving no threat to good faith bargaining.[42]

RICKY LEE WELBORN

Municipal Corporations—Constitutional Law—Eviction From Public Housing Projects

Public housing in the United States originated in the 1930's as part of the larger effort to escape from the clutches of the Great Depression. The Wagner-Steagall Act of 1937[1] signaled the entry of the federal government into the field of housing and, although amended many times, remains in force today with its basic design still largely intact. Today, more than one out of every one hundred persons in the United States lives in federally assisted, low-rent public housing.[2]

[40] *Id.* According to Mr. Hilderbrand, taking wages out of competition among unions is the most sought after goal of the unions.

[41] *Cf.* NLRB v. John J. Corbett Press, Inc., 401 F.2d 673 (2d Cir. 1968); NLRB v. Sheridan Creations, Inc., 357 F.2d 245 (2d Cir. 1966).

[42] It should be noted that employers may join together in multi-employer associations for the purpose of collective bargaining, if done in good faith and with the consent of the union, with each party retaining the right to withdraw from this bargaining arrangement upon reasonable notice. *See* NLRB v. Truck Drivers, Local 449, 353 U.S. 87 (1957); Publishers' Ass'n of New York City v. NLRB, 364 F.2d 293 (2d Cir.), *cert. denied*, 385 U.S. 971 (1966); Pacific Coast Ass'n of Pulp & Paper Mfrs., 163 N.L.R.B. No. 129 (1967); Retail Associates, Inc., 120 N.L.R.B. 388 (1958).

[1] 50 Stat. 888 (1937), *as amended*, 42 U.S.C. §§ 1401-30 (1964), *as amended*, 42 U.S.C. §§ 1402-21a (Supp. III, 1968).

[2] Rosen, *Tenants' Rights in Public Housing*, in HOUSING FOR THE POOR: RIGHTS

Although reformers had long urged public intervention to alleviate the deplorable conditions of the slums, the Wagner-Steagall Act was motivated "not so much as a matter of radical ideology, but out of a demand for positive programs to eliminate the 'undeserved' privations of the unaccustomed poor."[3] This attitude resulted from the peculiar character of the persons burdened by poverty in the thirties. In addition to the "problem poor" (the traditional uneducated, unskilled poor), there were millions of persons whose style of living was reduced to the poverty level by the Depression. These persons, formerly prosperous with a middle-class outlook, constituted a "submerged middle class,"[4] and it was this group who initially benefitted from subsidized public housing.

> The projects were for poor but honest workers—the members of the submerged middle class, biding their time until the day when they regained their rightful income level. The tenants were not to receive any "charity." The difference between a dole and a subsidy is psychologically powerful, whether or not the distinction is good economics. The working class residents of public housing were not to receive a gift from the government, but their rightful due as citizens. Public housing, arguably, was no more "charitable" than the free land of the Homestead Act of 1862—an earlier form of middle-class subsidy. Decent, sanitary apartments were a stepping-stone to a fee simple cottage—the American dream. Perhaps a radical fringe of housing reformers looked on public housing as something more fundamentally "public"; but the core of support lay in an old and conservative tradition.[5]

Public housing activities were suspended during World War II. The return of prosperity ended the phenomenon of a submerged middle-class and consequently the demand for low-rent public housing by these persons.[6] "Public housing . . . was relegated to the permanent poor in the city, and to the new urban immigrants. . . . [P]ublic housing was exclusively for those who were certainly, indisputably, irreversibly poor."[7]

AND REMEDIES 154 n.1 (1967) [hereinafter cited as Rosen]; see generally Friedman, *Public Housing and the Poor: An Overview*, 54 CALIF. L. REV. 642 (1966) [hereinafter cited as Friedman].

[3] Friedman 646.

[4] *Id.*

[5] *Id.* at 648-49.

[6] Actually, many would have been content to remain in subsidized public housing projects. However, pressures on the government by business interests resulted in the abandonment of subsidized apartments for homes in the suburbs. *Id.* at 651.

[7] *Id.*

> The texture of life in the projects changed for the worse; since more delinquent families lived in them, they were the locus for more and more delinquency. The attention of the public was now directed to public housing not

Influx of the "problem poor" has altered the whole complexion of public housing. The location in a public housing project of a poverty-stricken family, with a history of substandard living spanning several generations, cannot be expected to transform its members into a respectable household with middle-class standards, values, outlooks and all the implications thereof. Consequently, public housing administrators have become more and more rigid and paternalistic in their attitudes toward tenants.

> As problems with tenants have multiplied, public housing officials have become increasingly authoritarian in their approach. Tenants are bound by complex regulations, much more stringent than those imposed by private landlords. Admission and continued occupancy standards are used as weapons for inculcating middle-class standards, and as shields for protecting the image of the program.[8]

Public housing tenants have had little opportunity to challenge the inevitable injustices resulting from these attitudes. However, with the recent explosion of legal services for the poor, public landlords can no longer remain secure in the belief that their actions will continue to go unchallenged.

One of the most onerous conditions imposed on tenants of public housing projects is that they be content with short-term leases, almost always providing for a month-to-month tenancy. By virtue of these lease terms, housing authorities have contended that they may terminate the lease of any tenant merely by giving the requisite notice to quit and that they are under no duty to give any reason for the eviction.[9] In *Thorpe v. Housing Authority*,[10] the Supreme Court had an opportunity to decide whether a public housing authority may, consistent with due process, evict a tenant for any reason or for no reason, and whether a tenant may be

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as a hopeful program of reform but as the site of public folly and private decay . . . .

Id. at 652.

[8] Comment, *Government Housing Assistance to the Poor*, 76 YALE L.J. 508, 512 (1967). *See* Fortas, *Equal Rights—For Whom?*, 42 N.Y.U.L. REV. 401, 413 (1967) [hereinafter cited as Fortas]; Friedman 655-56; Rosen 156.

[9] See Fortas 412; Friedman 660; Rosen 185 & n.67, 203-04. Public housing authority admission policies have also been attacked. See Holmes v. New York City Housing Auth., 398 F.2d 262 (2d Cir. 1968); Friedman 656-59; Rosen 157-81. Also contested have been rules and regulations promulgated by the authorities, compliance with which is a condition to admission and continued occupancy. See Lewis v. Housing Auth., 397 F.2d 178 (5th Cir. 1968); Rosen 224-46. Discussion of these controversial policies is beyond the scope of this note.

[10] 393 U.S. 268 (1969).

evicted without being afforded an opportunity to contest the sufficiency of the authority's reason for terminating the tenancy.

Petitioner Thorpe resided in a federally assisted, low-rent public housing project owned and operated by the Housing Authority of the City of Durham, North Carolina. Petitioner's lease provided for a renewable month-to-month tenancy and also provided for termination of the tenancy by either party on fifteen days notice prior to the end of any monthly term. On August 10, 1965, petitioner was elected president of a tenants' organization, and on August 11 she was given notice that her lease would be terminated at the end of the month. No reason was given for the termination and efforts to ascertain the reason were unsuccessful.[11]

In defending against the Housing Authority's action for summary eviction, petitioner asserted that she was being evicted for her organizational activities and that eviction for this reason would be in violation of her first amendment rights. The North Carolina state courts sustained the Housing Authority's power to evict petitioner, the supreme court stating: "It is immaterial what may have been the reason for the lessor's unwillingness to continue the relationship of landlord and tenant after the expiration of the term as provided in the lease."[12] Subsequently, the Supreme Court granted certiorari to consider whether petitioner was denied due process.[13] While the case was pending before the Court, the Department of Housing and Urban Affairs (hereinafter HUD) issued a circular concerning the termination of tenancies in public housing projects. The circular provided that "no tenant be given notice to vacate without being told by the Local Authority, in a private conference or other appropriate manner, the reasons for the eviction, and given an opportunity to make such reply or explanation as he may wish."[14] The Supreme Court then vacated the *Thorpe* judgment and remanded to the North Carolina Supreme Court for further proceedings in light of the circular.[15] The North Carolina Supreme Court reaffirmed its previous decision holding that

[11] *Id.* at 270-71 & nn.1, 2 & 3.

[12] Housing Auth. v. Thorpe, 267 N.C. 431, 433, 148 S.E.2d 290, 292 (1966) (per curiam).

[13] Thorpe v. Housing Auth., 385 U.S. 967 (1966).

[14] Thorpe v. Housing Auth., 393 U.S. at 272-73 n.8.

[15] Thorpe v. Housing Auth., 386 U.S. 670 (1967). In a concurring opinion, Justice Douglas stated: "I would vacate and remand to the state courts to determine the precise reason why petitioner was evicted and whether that reason was within the permissible range for state action against the individual." *Id.* at 681.

the circular was prospective only and thus was not applicable to the petitioner's case.[16]

Once again the Supreme Court granted certiorari[17] and reversed the judgment, holding that "housing authorities of federally assisted public housing projects must apply the . . . HUD circular before evicting any tenant still residing in such projects. . . ."[18] Specifically, the Court held that the HUD circular is mandatory;[19] that the circular did not unconstitutionally impair the Housing Authority's contract with HUD nor the Authority's lease agreement with the petitioner;[20] and that the circular is applicable to eviction proceedings instituted prior to the issuance of the circular.[21] Beyond these holdings, the Court's decision provides little, if any, guidance as to what types of procedure would constitute compliance with the HUD circular.[22] Invoking the abstention doctrine,[23] the Court also failed to resolve any of the larger Constitutional issues concerning the applicability of due process limitations to a public housing authority's power of eviction.[24]

That a public housing authority is an arm of the state—usually termed a municipal corporation, created for a public purpose, and invested with a government function—is virtually undisputed.[25] However, public housing authorities have insisted that they stand on the same footing as private landlords and thus are bound only by the terms of the lease agree-

[16] Housing Auth. v. Thorpe, 271 N.C. 468, 471, 157 S.E.2d 147, 150 (1967).

[17] Thorpe v. Housing Auth., 390 U.S. 942 (1968).

[18] 393 U.S. at 274.

[19] *Id.* at 274-76.

[20] *Id.* at 277-81.

[21] *Id.* at 281-83. The Court noted that the Housing Authority had begun to comply with the HUD circular but refused to apply it to petitioner because it had decided to evict her before the circular was issued. *Id.* at 283.

[22] In fact, the Court may have inadvertently minimized the effect of the circular by quoting with apparent approval the Authority's contention that "the Circular clearly does not say that a Housing Authority cannot terminate at the end of any term without cause as is provided in the lease." *Id.* at 278.

[23] See Ashwander v. TVA, 297 U.S. 288, 346-48 (1936) (Brandeis, J., concurring).

[24] 393 U.S. at 270 n.2, 284 & n.49.

> These same considerations lead us to conclude that it would be . . . premature for us to reach a decision on petitioner's contention that it would violate due process for the Authority to evict her arbitrarily. That issue can be more appropriately considered if petitioner is in fact evicted arbitrarily.

Id. at 284 n.49.

[25] *E.g.*, Banks v. Housing Auth., 120 Cal. App. 2d 1, 260 P.2d 668 (1953); Cox v. City of Kinston, 217 N.C. 391, 8 S.E.2d 252 (1940). *Cf.* Shelley v. Kraemer, 334 U.S. 1 (1948).

ments into which they enter.[26] The courts have generally upheld this view with the result that a public housing authority, like a private landlord, may evict a tenant for whatever reason it chooses, subject only to the provisions of the lease agreement.[27] It follows that where the lease does not specifically provide for termination, a public housing tenant, in possession under a month-to-month tenancy, can be evicted for any reason merely by landlord compliance with the statutory requirements for the termination of such tenancies.[28]

In the fifties a notable exception to this general attitude grew out of the public housing authorities' attempt to comply with the Gwinn Amendment[29] by requiring tenants to sign a statement to the effect that they were not members of any organization designated as subversive by the Attorney General. Failure to sign such a statement would result in eviction. The courts consistently held that evictions based on such grounds were arbitrary and in violation of the tenants' constitutional rights.[30]

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[26] See Friedman 660-61; Rosen 184-85; Comment, *Public Landlords and Private Tenants: The Eviction of "Undesirables" from Public Housing Projects*, 77 YALE L.J. 988 (1968) [hereinafter cited as Comment, *Public Landlords and Private Tenants*]. *See also* Reich, *The New Property*, 73 YALE L.J. 733 (1964).

[27] *E.g.*, Brand v. Chicago Housing Auth., 120 F.2d 786 (7th Cir. 1941); Housing Auth. v. Thorpe, 267 N.C. 431, 148 S.E.2d 290 (1966) (per curiam); Housing Auth. v. Turner, 201 Pa. Super. 62, 191 A.2d 869 (1963). At times 42 U.S.C. § 1404a (1964), *as amended* (Supp. III, 1968), has been interpreted to authorize such action. *E.g.*, Walton v. Phoenix, 69 Ariz. 26, 208 P.2d 309 (1949). That section provides that "any State or local public agency administering a low-rent housing project . . . shall continue to have the right to maintain an action or proceeding to recover possession of any housing accommodations operated by it where such action is authorized by the statute or regulations under which such housing accommodations are administered . . . ." However, an examination of legislative history shows that the provision was included to insure that a local authority could evict a tenant who became ineligible for low-rent housing because of exceeding maximum income requirements. See 93 CONG. REC. 6044 (1947). In fact, the only ground for eviction from a public housing project mentioned specifically in the federal act is eviction for "overincome." 42 U.S.C. § 1410(g)(3) (1964), *as amended* (Supp. III, 1968).

[28] *E.g.*, the North Carolina statute provides for termination of a month-to-month tenancy on seven days' notice prior to the end of any term. N.C. GEN. STAT. § 42-14 (1965).

[29] "[N]o housing unit constructed under the United States Housing Act of 1937, as amended, shall be occupied by a person who is a member of an organization designated as subversive by the Attorney General." 66 Stat. 403, *reenacted* 67 Stat. 307, *formerly* 42 U.S.C. § 1411(c) (Supp. 1953), expiring with its omission in 1955.

[30] Rudder v. United States, 226 F.2d 51 (D.C. Cir. 1955); Housing Auth. v. Cordova, 130 Cal. App. 2d 883, 279 P.2d 215, *cert. denied*, 350 U.S. 969 (1956); Chicago Housing Auth. v. Blackman, 4 Ill. 2d 319, 122 N.E.2d 522 (1954); Kutcher v. Housing Auth., 20 N.J. 181, 119 A.2d 1 (1955); Lawson v. Housing Auth., 270 Wis. 269, 70 N.W.2d 605 (1955).

The Gwinn amendment cases contain an abundance of dicta concerning limitations on the power of a public housing authority to evict a tenant for no reason or for an arbitrary reason. Perhaps the most well-known of these dicta is contained in *Rudder v. United States*[31] where the court stated: "The government as landlord is still the government. It must not act arbitrarily, for, unlike private landlords, it is subject to the requirements of due process of law. Arbitrary action is not due process."[32] The effect of *Rudder* and similar dicta on subsequent evictions by public housing authorities is not at all clear.[33] For example, in *Holt v. Richmond Redevelopment & Housing Authority*,[34] the court enjoined the eviction of a public housing tenant because it found that the tenant was being evicted for his participation in establishing a tenants' organization and for being elected its president. Citing *Rudder*, the court held that eviction on such grounds would constitute an invalid infringement on the tenant's first amendment rights of freedom of speech and freedom of assembly. At the same time the court stated that a public housing tenant has no vested right in his tenancy, thus implying that any reason not constituting an infringement on constitutional rights would be sufficient for eviction.[35]

Consequently, when faced with eviction from a public housing project, the tenant, in an attempt to ascertain his rights, must look to a vaguely-defined HUD circular and to a series of cases on the subject that are confusing and often inconsistent. Further clarification by the courts is inevitable and thus it would be useful to predict what type of clarification will be forthcoming.

Initially, it should be recognized that the public housing tenant threatened with eviction has a great deal at stake. In addition to the immeasurable emotional implications of an eviction, the tenant is faced with

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[31] 226 F.2d 51 (D.C. Cir. 1955).

[32] 226 F.2d at 53. See also Housing Auth. v. Cordova, 130 Cal. App. 2d 883, 884, 279 P.2d 215, 216, *cert. denied*, 350 U.S. 969 (1956):

> We believe it fairly obvious that a public body, a housing authority as here, does not possess the same freedom of action as a private landlord, who is at liberty to select his tenants as he pleases, and in the absence of a letting for a prescribed term, may terminate their tenancy either without any reason or for any reason regardless how arbitrary or unreasonable it may be.

[33] *Compare* Housing Auth. v. Turner, 201 Pa. Super. 62, 191 A.2d 869 (1963), *with* Thomas v. Housing Auth., 282 F. Supp. 575 (E.D. Ark. 1967).

[34] 266 F. Supp. 397 (E.D. Va. 1966).

[35] *Id.* at 400-01. *See* Chicago Housing Auth. v. Stewart, — Ill. 2d —, 237 N.E.2d 463 (1968); Lancaster Housing Auth. v. Gardner, 211 Pa. Super. 502, 240 A.2d 566 (1968).

the task of relocating. Because of a critical housing shortage, he will often have to be satisfied with a substandard dwelling at a higher rent payment and his chances of ever being admitted to another public housing project are severely diminished.[36] On the other hand, it is clear that public housing authorities must have sufficient power to control their internal affairs, to maintain order, and to protect project property.[37] However, if the authorities impinge upon the rights and privileges of their tenants in purportedly carrying out these functions, it is incumbent upon the courts to intervene and protect these rights and privileges.[38]

In light of recent Supreme Court decisions, it seems obvious that an eviction based on an authority's displeasure with a tenant's exercise of his constitutional rights cannot be upheld.[39] "It is too late in the day to doubt that the liberties of religion and expression may be infringed by the denial of or placing of conditions upon a benefit or privilege."[40] In fact, in *Thorpe* the Court noted with approval the Housing Authority's concession that "its power to evict is limited at least to the extent it may not evict a tenant for engaging in constitutionally protected activity. . . ."[41] This conclusion points up the need for affording the tenant notice and an opportunity to be heard before he can be evicted. As the Court noted in *Thorpe*: "[A] tenant would have considerable difficulty effectively defending against such an . . . illegal eviction if the Authority were under no obligation to disclose its reasons."[42]

Assuming that a public housing authority cannot evict a tenant for engaging in constitutionally protected activity, it remains to be determined whether a public housing tenant can be evicted for any other reason or for no reason at all. At the outset, it is important to distinguish the function of a public landlord from that of a private landlord.

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[36] Comment, *Public Landlords and Private Tenants* 990-91.

[37] *See* 42 U.S.C. § 1401 (1964).

[38] *See* Rosen 247.

[39] For a recent case indicating that a private landlord may, under certain circumstances, be prohibited from evicting a tenant because of his constitutionally protected activities, see Edwards v. Habib, 397 F.2d 687, 690-99 (D.C. Cir. 1968).

[40] Sherbert v. Verner, 374 U.S. 398, 404-05 & n.6 (1963). See also Elfbrandt v. Russell, 384 U.S. 11 (1966); NAACP v. Button, 371 U.S. 415 (1963); Shelton v. Tucker, 364 U.S. 479 (1960); Speiser v. Randall, 357 U.S. 513 (1958); NAACP v. Alabama, 357 U.S. 449 (1958); Slochower v. Board of Higher Educ., 350 U.S. 551 (1956); Wieman v. Updegraff, 344 U.S. 183 (1952).

[41] 393 U.S. at 282-83 & n.44.

[42] *Id.* at 283. *Cf.* Silver v. New York Stock Exch., 373 U.S. 341, 362-63 (1963); Cafeteria & Restaurant Workers Union v. McElroy, 367 U.S. 886, 900 (1961) (Brennan, J., dissenting).

> Public housing authorities do not hold housing projects for profit and so have no need for such broad freedom to terminate their relationship with project residents. The authorities' only legitimate interest in their property is in its usefulness as a tool of national and state housing policies. . . . The public landlord, in short, does not require the broad discretion of a private landlord.[43]

Second, the old distinction between "right" and "privilege," including the notion that constitutional limitations are not applicable to the denial or revocation of a privilege,[44] has lost much of its vitality.[45] Because of the obvious parallelism between the government as employer and the government as landlord, the Court's language in *Wieman v. Updegraff*[46] is relevant. "We need not pause to consider whether an abstract right to public employment exists. It is sufficient to say that constitutional protection does extend to the public servant whose exclusion pursuant to a statute is patently arbitrary or discriminatory."[47] Third, the argument is often made that the lease provisions to which the public housing tenant agrees determine the rights and incidents of his tenancy; consequently, a reservation by the authority of the power to terminate on short notice is exclusively controlling. However persuasive such an argument might be in the case of a private landlord, it cannot be sustained where the landlord is an arm of the government. "[T]he state cannot condition the granting of even a privilege upon the renunciation of the constitutional right to procedural due process."[48]

In *Thorpe* the Court at least hinted at its recognition of these distinctions between public and private landlords. This hint came in the form of a footnote citing the concurring opinion of Justice Douglas in

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[43] Comment, *Public Landlords and Private Tenants* 996-97.

[44] See generally Reich, *The New Property*, 73 YALE L.J. 733 (1964); Van Aystyne, *The Demise of the Right-Privilege Doctrine in Constitutional Law*, 81 HARV. L. REV. 1439 (1968).

[45] See, *e.g.*, Sherbert v. Verner, 374 U.S. 398 (1963); Willner v. Committee on Character and Fitness, 373 U.S. 96 (1963); Speiser v. Randall, 357 U.S. 513 (1958).

[46] 344 U.S. 183 (1952).

[47] *Id.* at 192.

[48] Dixon v. Alabama State Bd. of Educ., 294 F.2d 150, 156 (5th Cir. 1961). *See* Vinson v. Greenburgh Housing Auth., 29 A.D.2d 338, 288 N.Y.S.2d 159 (Sup. Ct. App. Div. 1968).

> [S]ince their landlord functions are incidental to the administration of national and state laws, not the converse, courts should look beyond the terms of 'leases' to the statutory standards which bind the administrator and to the constitutional standards which the government must respect whenever and through whomever it acts.

Comment, *Public Landlords and Private Tenants* 999-1000.

the Court's previous *Thorpe* decision.[49] In that opinion Justice Douglas cited with approval the *Rudder* dictum that "the government as landlord is still the government" and thus is subject to the constitutional limitations of due process.[50] Furthermore, the Court indicated its willingness when the issue is properly before it to consider to what extent the constitutional limitations of due process restrict a public housing authority in its dealings with tenants.[51]

Meanwhile, public housing authorities are bound by the HUD circular to give any tenant it wishes to evict notice of the reasons for the eviction and an opportunity to respond. Therefore, the implementation and interpretation of these requirements will, to a large extent, determine the future role of the courts in litigation of this kind.[52] It seems almost certain, however, that courts will be called upon to decide what types of reasons are sufficient to evict a tenant from a public housing project and to establish guidelines to insure that the tenant will be given a fair hearing before he may be evicted. As to the proceeding, some sort of trial-type hearing would seem to be appropriate,[53] with the tenant having an opportunity to present his case and to confront the authority with respect to the legality and sufficiency of its reasons for the eviction.[54] Furthermore, it is imperative that the public housing administrator urging eviction should not be in a position to decide the legality and sufficiency of the reasons underlying his decision. "That a conclusion satisfies one's private conscience does not attest its reliability."[55]

It would be easy to criticize the *Thorpe* decision for not setting forth the extent to which public housing authorities are bound by considerations of due process, and such criticism will undoubtedly be forthcoming.

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[49] 393 U.S. at 283 n.45.

[50] 386 U.S. at 678.

[51] 393 U.S. at 289 n.49.

[52] For an early interpretation of the circular, see Lancaster Housing Auth. v. Gardner, 211 Pa. Super. 502, 240 A.2d 566 (1968).

[53] See Rosen 211.

[54] *Cf.* Greene v. McElroy, 360 U.S. 474 (1959).

[55] Joint Anti-Fascist Refugee Comm. v. McGrath, 341 U.S. 123, 171 (1951) (Frankfurter, J., concurring). Justice Frankfurter continued:

> The validity and moral authority of a conclusion largely depend on the mode by which it was reached. Secrecy is not congenial to truth-seeking and self-righteousness gives too slender an assurance of rightness. No better instrument has been devised for arriving at the truth than to give a person in jeopardy of serious loss notice of the case against him and an opportunity to meet it. *Nor has a better way been found for generating the feeling, so important to a popular government, that justice has been done.*

Id. at 171-72 (emphasis added).

On the other hand, and perhaps more importantly, the decision clearly puts public housing officials on notice that their actions in the future will be subject to judicial scrutiny. Hopefully, this factor will cause public housing officials to reëvaluate their attitudes and to bring their policies into line with the goals and purposes underlying the public housing program.[56]

Advocates of the system of justice found in the United States have often compared it favorably with judicial practices in other countries. Yet that very system has too often permitted those of our citizens who are dependent on government assistance in such areas as public housing to be treated "as nonpersons in a constitutional sense; as persons who have, in return for welfare payments, surrendered to the state's social workers their constitutional rights to privacy and personal security."[57] To permit this state of affairs to continue would be intolerable.

> We need not go so far as to embrace the argument that the state has a constitutional duty to provide its indigent citizens with support; but if the state chooses to do so, it must proceed with careful regard to the rights of the recipients, for they, too, are persons within our constitutional scheme. Indeed, it may be that in the final analysis, a nation is measured—perhaps its future is determined—not by the protection which its institutions afford to the rich and strong, but by the meticulous care with which the rights of the weak and humble are safeguarded.[58]

MICHAEL R. ABEL

Real Property—Tenancy by the Entirety in Real Property During Marriage

In determining the respective rights and interests of husband and wife (*H* and *W*) in jointly held real property, the common law accepted literally the Biblical statement that *H* and *W* are one. This legal fiction of "unity of person" was utilized to vest title to the real property in *H* and *W* simultaneously, *i.e.*, both owned the whole estate with neither holding

[56] "Because serious injury attends eviciton from public housing, the threat of termination is a dangerous weapon. Used carelessly, it can create a hostile, bitter atmosphere in a housing project. Tenants, made to feel insecure, begin to distrust each other as well as project officials."
Comment, *Public Landlords and Private Tenants* 991.

[57] Fortas 413.

[58] *Id.* at 414.

a divisible portion.[1] This estate is called a tenancy by the entirety and is presently recognized in twenty-two jurisdictions,[2] but its incidents have been modified in most states.[3]

The common law incidents of tenancy by the entirety can be summarized as follows: *H* alone had the right to manage and control the property and was entitled to all rents and profits without having to account to *W*. He could thus lease, mortgage, or convey the property, but subject to *W*'s contingent right of survivorship. Although *H*'s creditors could reach his right to the rents and profits during the marriage, *W*'s creditors had no recourse against the property during coverture. The estate was, however, liable for the joint obligations of *H* and *W*. Each spouse had a contingent right of survivorship that could not be defeated by either spouse alone during the marriage. On the death of either *H* or *W*, the right of survivorship vested the entire fee in the surviving spouse. If *W* survived, she was not bound by any encumbrance of the realty in which she did not join.[4] Thus, the basic theory of the tenancy of the entirety at common law was that there was unity of the spouses with *H* in control of the realty.

Decisions of the North Carolina Supreme Court show that North

[1] 4 R. POWELL, REAL PROPERTY ¶¶ 621-24 (1968) [hereinafter cited as POWELL]; Huber, *Creditors' Rights in Tenancies by the Entireties*, 1 B.C. IND. & COM. L. REV. 197 (1960); Lee, *Tennacy by the Entirety in North Carolina*, 41 N.C.L. REV. 67 (1962); Phipps, *Tenancy by Entireties*, 25 TEMP. L.Q. 24 (1951) [hereinafter cited as Phipps]. Tenancies by the entirety and joint tenancies with survivorship should not be confused. The basic distinction is that an estate by the entirety can only exist between H and W, whereas a joint tenancy may exist between any number of persons with each tenant having a specific and identifiable interest. In a joint tenancy the interest of each tenant may be executed against for his debts. In most entirety jurisdictions this is not the case. *Id.* at 35-41; POWELL ¶¶ 616-18.

[2] POWELL ¶ 621, at 685 n.7. MISS. CODE ANN. § 834 (1956) allows creation of a tenancy by the entirety with right of survivorship if it manifestly appears that the estate was intended. Cuevas v. Cuevas, — Miss. —, 191 So. 2d 843 (1966).

[3] In Delaware, District of Columbia, Florida, Indiana, Kentucky, Missouri, Pennsylvania, Rhode Island, Vermont, Virginia, and Wyoming the common law has been modified so that there is joint use and disposition of the rents and profits. *See* Phipps 46-57. One writer includes Tennesssee and Maryland in this group. *Id.* Seven jurisdictions have gone even further and hold that each spouse is entitled to one-half the rents and profits, and use. Pilip v. United States, 186 F. Supp. 397 (D. Alas. 1960); Franks v. Wood, 217 Ark. 10, 228 S.W.2d 480 (1950); *In re* Dean's Trust, 47 Hawaii 629, 394 P.2d 432 (1964) (inference); Wardrop v. Wardrop, 211 Md. 14, 124 A.2d 576 (1956); Dvorken v. Barrett, 100 N.J. Super. 306, 241 A.2d 841 (1968); College Point Sav. Bank v. Tomlinson, 42 Misc. 2d 1061, 249 N.Y.S.2d 938 (Sup. Ct. 1964); Brownley v. Lincoln County, 218 Ore. 7, 343 P.2d 529 (1959). *But see* POWELL ¶ 623 at 703, and Phipps 46-57, who cite only Arkansas, New Jersey, New York, and Oregon in this group.

[4] Material cited note 1 *supra*; *contra*, Note, 14 RUTGERS L. REV. 457 (1960).

Carolina is a "strong" tennacy by the entirety state, *i.e.*, North Carolina adheres to the foregoing common law incidents.[5] Despite its well established traditions, however, changing times continue to produce new situations with which the tenancy must deal. This note will examine some of the continued legal problems raised by the estate by the entirety in real property in North Carolina during the joint lives of the spouses.

The extent of modern day marital problems was unfamiliar to the common law history of the tenancy by the entirety. In today's setting, however, it has been necessary to deal by statute with the effect of the estate on *W*'s right to alimony. Rents and profits from entirety property in North Carolina may be charged with the support of *W* in an action for alimony or alimony pendente lite without divorce.[6] A prior statute[7] allowed the court to issue a writ of possession that gave *W* control of the property so that she could apply the rents and profits, when they had accrued and become personalty, to pay the alimony and counsel fees. Yet, *W* could not get title to the property. Under a new statute enacted by the 1967 General Assembly,[8] if *W* is separated from *H* and is seeking alimony or alimony pendente lite without divorce, the superior court can order payment to *W* by transfer of title or possession of personal property, or an interest therein, or by a security interest in or possession of real property.[9] A subsection[10] gives the court power to order transfer of title to real property under N.C. GEN. STAT. §§ 1-277 and 1-278. Thus, in this domestic setting, the tenancy by the entirety can be conveyed to *W* by the superior court without the joinder or consent of *H*, thereby establishing a statutory exception to the common law rule of exclusive possession and control by *H* during the marriage.

A voluntary transfer of entirety property by both spouses terminates the tenancy and the proceeds are held by *H* and *W* as tenants in common. Where the transfer is involuntary, however, more serious problems may arise.[11] In *North Carolina Highway Commission v. Myers*,[12] the proceeds from the condemnation of entirety property were deposited with the clerk of superior court. *W* brought an action seeking a greater condemnation

[5] Nesbitt v. Fairview Farms, Inc., 239 N.C. 481, 80 S.E.2d 472 (1954).
[6] Porter v. Citizens Bank, Inc., 251 N.C. 573, 111 S.E.2d 904 (1960).
[7] N.C. GEN. STAT. § 50-17 (1966).
[8] N.C. GEN. STAT. § 50-16.7 (Supp. 1967).
[9] *Id.*
[10] *Id.* (c).
[11] Wilson v. Ervin, 227 N.C. 396, 42 S.E.2d 468 (1947).
[12] 270 N.C. 258, 154 S.E.2d 86 (1967).

award from the state, but also asked that a portion of the deposit be distributed to her pending her current action for alimony without divorce. The North Carolina Supreme Court ruled that an involuntary conveyance of title did not destroy the estate; the compensation award had the same status as the real property that had been owned by the entireties. Thus, *W* had no present right to any portion of the proceeds since neither spouse has a separate interest in the entirety realty.

The North Carolina Supreme Court has also ruled that a private sale under a state statute[13] authorizing such sale when land is held by the entireties and one spouse is incompetent, is an involuntary transfer.[14] The court held that the entirety nature of the estate was not destroyed, but that the right of survivorship attached to the fund. It was further held, however, that *H* held the corpus as trustee for the survivor.[15] Thus, where *W* is incompetent, her interest in the proceeds from an involuntary sale of the entirety property is protected by *H*'s fiduciary status. In the typical situation, however, *W*, even though competent, can not protect her interest in the entirety realty or the proceeds. If *W* continues to live with *H* even though there are serious marital difficulties, or where she is separated from *H* but not seeking alimony, her contingent interest could be destroyed. The proceeds from an involuntary sale are paid to *H* and he would continue to be legally entitled to control the proceeds since they represent the real property. In these latter situations there is no safeguard after payment to prevent an inconsiderate or irresponsible *H* from wasting the entire proceeds, thereby destroying *W*'s contingent right of survivorship, which could not have been defeated by *H*'s individual attempt to convey the realty itself.

One solution to this problem would be to hold *H* as trustee of involuntary sale proceeds for the survivor, even when *W* is competent, rather than simply giving the proceeds to him with no safeguards. Under such an approach, *H* would at least be bound by the usual rules of conduct for a fiduciary and could be made to account if he was delinquent in his duties as trustee. Even then, however, a judicial decree would be of little comfort or benefit to *W* if *H* were insolvent or without assets.

In order to provide *W* with protection when there is disharmony in the marriage, the fund could be deposited in a savings account in the name of *H* and *W* as tenants by the entirety with *H* entitled to the

[13] N.C. GEN. STAT. 35-14 (1935).
[14] Perry v. Jolly, 259 N.C. 306, 130 S.E.2d 654 (1963).
[15] *Id.* at 314, 130 S.E.2d at 661.

interest during the spouses' joint lives and with the survivor entitled to the cash account. A more ideal arrangement might be to authorize the superior courts by statute to appoint a bank or savings and loan company as trustee to invest the fund from an involuntary transfer and order it to pay a reasonable return to *H* with the remainder being accumulated to be paid with the principal to the survivor. Under either arrangement, *H* continues to be entitled to the profits from the estate, but the desired protection is provided for *W*'s contingent right of survivorship.

In determining the respective rights of the spouses to insurance proceeds, North Carolina does not treat the loss of insured entirety property as an involuntary transfer. The North Carolina Supreme Court ruled in *Carter v. Continental Insurance Company*[16] that although the *H* had an insurable interest in entirety property,

> since the proprietary interest of the husband was an inseparable part of the single-entity title held in unity by him and the wife, his insurable interest ran to the whole property and covered the entire estate . . . . [T]he loss benefits created thereby inured to the entire estate . . . .[17]

Since an absolute divorce had terminated the estate subsequent to the fire, the court held *W* was entitled to one-half the proceeds.[18] In a recent decision,[19] the North Carolina Court of Appeals held that insurance proceeds from entirety property received before divorce is personal property, there being no involuntary conversion. The *H* had requested that the fund be deposited in joint savings accounts to the credit of *H* and *W* with right of survivorship, but with the interest payable to *H*. The court upheld the trial court's determination that one-half was to be distributed to each spouse.

Thus, even if a spouse paid all the premiums and had the policy issued in his name alone, the spouse still could not insure to the exclusion of the other spouse. In the insurance area, the "oneness" of the spouses requires that the insurance policy, although purchased by one spouse through a contract with a third party, belongs to both. As a practical matter, the loss of the insured structure can result in a diminution of the rents and

[16] 242 N.C. 578, 89 S.E.2d 122 (1955). *Accord,* Shores v. Rabon, 251 N.C. 790, 112 S.E.2d 556 (1960) (dictum).

[17] 242 N.C. at 580, 89 S.E.2d at 124. *But see* Henderson v. Stuart, 221 N.C. 37, 18 S.E.2d 705 (1942) (holding *H* had the right to use some of the proceeds of a fire policy to pay individual indebtedness).

[18] For a thorough discussion of the *Carter* case, see Note, *Fire Insurance—Estates by the Entirety—Insurable Interest—Right to Proceeds,* 35 N.C.L. REV. 134 (1956).

[19] Forsyth County v. Plemmons, 2 N.C. App. 373, 163 S.E.2d 97 (1968).

profits going to *H*, even though the land is still there. It would seem therefore that *H*, if he pays all the premiums should be entitled to all the insurance proceeds.

One of the most fertile sources of problems continuing to arise under the tenancy by the entirety is the broad area of creditors' claims. North Carolina has consistently followed the common law immunity of the entirety estate to the separate debts of the spouses, even recently applying it to a political subdivision's attempts to avoid this incident. In *Duplin County v. Jones*,[20] land was owned by the entirety, but listed on the tax records in the name of *H* alone. A county tax on separate personal property owned by *H* and by *W* was not paid. The court held that no lien attached to the tenancy by the entirety because of the unpaid tax levied upon either spouse's separately owned property. Not only a private creditor then, but the state, can be frustrated by this incident of the estate in attempting to satisfy a claim.

Determining when one spouse alone acts for both is important to the creditor seeking to levy execution on entirety property for a joint obligation. North Carolina is in accord with the general rule that marriage alone does not make one spouse the agent of the other.[21] In *General Air Conditioning Company v. Douglass*,[22] *H* had contracted with the plaintiff to install a number of heating systems in homes constructed by *H*, a builder, and owned by the entirety. The plaintiff alleged that *H* was the agent of *W* in entering the written contract in question for the installation of the heating system in a home built for resale by *H*. The plaintiff thereby hoped to be able to levy execution upon the entirety property to satisfy what then would be a joint obligation. The plaintiff had knowledge, however, that all property was owned by the entireties, yet he admitted that he dealt exclusively with *H*, never talking to or reaching any agreement with *W*. A judgment of nonsuit for *W* was sustained. The court said that marriage did not make *H* the agent of *W*, nor did it create a presumption of agency.[23] To establish agency, said the court, it had to be proven. The court also found no evidence of ratification by word

[20] 267 N.C. 68, 147 S.E.2d 603 (1966).

[21] *E.g.*, Lo Medico v. Simkowitz, 158 A.2d 681 (D.C. Mun. Ct. App. 1960); Wohlmuther v. Mt. Airy Plumbing & Heating, Inc., 244 Md. 321, 223 A.2d 562 (1966); Vaughn v. Great American Ins. Co., 390 S.W.2d 622 (Mo. App. 1965); Falk v. Krumm, 39 Misc. 2d 448, 240 N.Y.S.2d 653 (Sup. Ct. 1963); Godwin Bldg. Supply Co. v. Hight, 268 N.C. 572, 151 S.E.2d 50 (1966).

[22] 241 N.C. 170, 84 S.E.2d 828 (1954).

[23] *Id.* at 173, 84 S.E.2d at 831.

or act of *W*. Neither could estoppel apply since no proof was offered that *W* by her words or conduct represented to anyone that *H* was her agent in the transaction.

As the rule now stands concerning agency between the spouses in North Carolina, a correct result was rendered under the facts of the *Douglass* case. However, where *W* is directly benefited by the work performed the question of agency is more difficult to resolve. *Grant v. Artis*[24] involved a suit brought against *H* and *W* for the price of electrical equipment and its installation in a dwelling that was owned by the entireties. Without reviewing the evidence below or even citing *Douglass*, the court in a per curiam opinion held that the evidence was sufficient to go to the jury for a determination of the question of whether *W* was a party to the contract for the services performed. Because the facts are not fully set forth it is hard to distinguish a difference between *Artis* and *Douglass*. The only apparent distinction between them is that there was a direct benefit to *W* from *H*'s actions in *Artis*, since the equipment was installed in a home that was occupied as a dwelling by the couple and not just held for resale as in *Douglass*. The record of appeal of the *Artis* case shows that the *W* had pointed out to the plaintiff where she wanted the stove to go in the house and where she wished other electrical outlets located.[25] The evidence was in conflict as to whether both *H* and *W* agreed with the plaintiff to pay for the work, but the jury found for the plaintiff.

The *Douglass* decision is a good example of an individual creditor of one spouse being prevented by the device of the entirety estate from collecting on his debt. Since *Artis*, however, a creditor may be able to at least get to the jury on some agency theory, even if *W* did not sign a writing, if *W* derived some direct benefit from the contract or if the creditor can show that *W* knew of the work and did not object. Also, the theory of ratification or estoppel is available on the proper set of facts.[26]

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[24] 253 N.C. 226, 116 S.E.2d 383 (1960).

[25] Brief for Appellant at 3, Grant v. Artis, 253 N.C. 226, 116 S.E.2d 383 (1960).

[26] Pennsylvania's rule is unique and seems to better balance the interest involved in the agency question. In J.R. Christ Constr. Co. v. Olevsky, 426 Pa. 343, 232 A.2d 196 (1967), *H* rented heavy equipment to grade farm land owned by the entirety to build a riding ring for their personal enjoyment. *W* had knowledge of the work, but she was not involved in the business transaction. The Pennsylvania Supreme Court affirmed a judgment for the plaintiff construction company and ruled that there is a presumption

> with respect to properties held by the entireties . . . that during the term of a marriage, either spouse has the power to act for both without specific authority, so long as the benefits of such action inure to both. This presumption . . . does not require knowledge on the part of the other spouse in question,

A tenancy by the entirety naturally lends itself to abuse by persons trying to escape creditors because of the property's immunity from levy for either spouse's separate debts. A debtor in North Carolina, however, can not defraud creditors by intentionally transferring his separate land to himself and his *W* as tenants by the entirety in order to avoid levy on the land for his debts.[27] The conveyance is deemed fraudulent on the theory that but for the conveyance the asset would have been a source from which creditors had a right to be paid.[28]

The North Carolina Supreme Court held in *Winchester-Simmons Company v. Cuttler*[29] that a conveyance by *H* and *W* of entirety property to a grandaughter was not fraudulent, even though the purpose and intent of the transfer was to prevent creditors from levying on the realty should *H* survive. *W* was in poor health at the time of the conveyance, and died soon thereafter. The court said that when the entirety land was conveyed *H* had only a contingent right of survivorship which could not be sold to satisfy the judgment.[30] Seven years after *Cuttler*, the court, following the common law rule, held in *Lewis v. Pate*[31] that creditors of *H* could levy upon the rents and profits of the estate to which *H* alone was entitled to satisfy his debts.[32] As a result of these two rulings, if the property conveyed to the granddaughter in *Cuttler* had been producing rents and profits, the important question arises whether the conveyance then would have been fraudulent since the creditors would be denied this present interest upon which to levy execution. The North Carolina Supreme Court chose recently not to avail itself of an opportunity to consider this question, and it was left to a concurring opinion to provide the probable answer.

In *L & M Gas Company v. Leggett*,[33] a judgment lien was obtained against *H* when land was held by the entirety. Subsequently *H* conveyed his interest to *W*. The judgment creditor sought to have the conveyance set aside as fraudulent. The court sustained a demurrer to the complaint,

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but only that it may be rebutted if, in fact, the spouse so acting was not authorized to act by the other spouse.

Id. at 345, 232 A.2d at 199.

[27] Sills v. Morgan, 217 N.C. 662, 9 S.E.2d 518 (1940).

[28] L & M Gas Co. v. Leggett, 273 N.C. 547, 161 S.E.2d 23 (1968).

[29] 199 N.C. 709, 155 S.E. 611 (1930).

[30] *Id.* at 714, 155 S.E. at 613.

[31] 212 N.C. 253, 193 S.E. 20 (1937).

[32] A receiver will not be appointed to rent the property in order to pay creditor's claims. Grabenhoffer v. Garrett, 260 N.C. 118, 131 S.E.2d 675 (1963).

[33] 273 N.C. 547, 161 S.E.2d 23 (1968).

reiterating that a tenancy by the entirety is not subject to the separate debts of either spouse. Justice Sharp in a concurring opinion[34] said the main question was whether it would be a fraudulent conveyance for a debtor *H* to convey to *W* his interest in income producing property held by the entirety. She concluded that such a transfer would not be fraudulent. She reasoned that land owned by the entireties is not subject to the claims of either spouse's creditors and an individual creditor's lien can not attach to the property unless the debtor spouse survives. The income, rents, and profits are personalty, not realty. In conveying his interest to *W*, *H* transfers the realty, which includes as an incident the right to all the profits, but does not actually convey the personalty. Therefore the transfer is not fraudulent since the property conveyed, *i.e.*, entirety property, could not be reached initially by the creditors to satisfy any individual claims against *H*.

This conclusion may initially seem unfair to creditors, but it is the only reasonable one considering the relevant incident of the estate by the entirety, *i.e.*, immunity from individual debts of the spouses. Since the spouses can convey the entire fee to a third party, they should be able together to convey the fee to either one or the other. If its income producing nature were to prevent the transfer of the entirety property because a fraud on creditors, the practical effect would be a restraint on alienation since potential purchasers would be concerned that a transfer could be set aside by creditors. The contrary argument, of course, is that the conveyance can be set aside only if it was made with the intent to defraud or hinder creditors. Thus, *H* and *W* need only negate any proof of intent to overcome the voiding of the transfer.[35]

ROBERT A. WICKER

Securities Regulation—Application of Rule 10b-5 to Open-Market Transactions

Securities trading in the United States is growing each year. Daily volume on the New York Stock Exchange now averages in excess of ten

[34] *Id.* at 553, 161 S.E.2d at 28.

[35] Since *H* alone is entitled to the rents and profits, if he assigned only his right to the income, individual creditors might successfully contend that this was a fraudulent transfer, provided the intent to defraud were present. In this instance *H* conveys not the land, but the personal property itself to defraud creditors, and the court has ruled that the rents and profits can be reached by individual creditors.

million shares, which represents an estimated monetary value of five hundred million dollars. Yet these transactions represent only a fraction of the total open-market transactions in the United States because there are dozens of other organized exchanges and an even larger over-the-counter market.

The public securities market is unique in that it is normally centralized, efficient, and highly sensitive in an economic sense. Theoretically, prices are determined by supply and demand, which in turn are heavily influenced by the information available about a particular security and general economic conditions. If a corporation whose stock is publicly traded were to issue any false information about its condition, a buyer or seller in the open-market who relied on this information could suffer severe losses. It would seem that if the investor has been wronged, he should be able to recover his losses; but the solution is not that simple.

In the recent case of *Heit v. Weitzen*,[1] the Court of Appeals for the Second Circuit addressed itself to this important question. This appeal represented the consolidation of two actions from the district court[2] that raised the same issues on essentially the same facts. In both cases, plaintiffs alleged that defendants, Belock Instrument Corporation and its directors, misrepresented the earnings of the corporation for fiscal year 1964 by failing to disclose that a substantial amount of its reported income was derived from various fraudulent overcharges on government contracts.[3] Relying on the misrepresentations contained in Belock's annual report, press releases, and documents filed with the Securities and Exchange Commission,[4] plaintiffs purchased Belock[5] securities on the American Stock Exchange and later allegedly suffered losses. At no time during the alleged fraud, however, did defendant corporation or any of its "insiders" trade in these securities. Nevertheless, plaintiffs contended

[1] 402 F.2d 909 (2d Cir. 1968), *petition for cert. filed*, 37 U.S.L.W. 3250 (U.S. Jan. 2, 1969) (No. 894).

[2] Heit v. Weitzen, 260 F. Supp. 598 (S.D.N.Y. 1966), *noted in* 35 FORD. L. REV. 565 (1967), and Howard v. Levine, 262 F. Supp. 643 (S.D.N.Y. 1965).

[3] On August 18, 1965, the grand jury in the Eastern District of New York returned a forty-one count indictment against certain officers of Belock charging them with presentation of false claims to the government. Brief for Appellee at 4, Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968).

[4] Hereinafter referred to as the SEC.

[5] On March 1, 1967, the name of defendant Belock was changed to Applied Devices Corporation. Brief for Appellee at 2, Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968).

that such actions by defendants violated section 10(b) of the Securities Exchange Act of 1934[6] and SEC Rule 10b-5,[7] promulgated thereunder.[8]

In both cases, the trial court granted defendants' motion to dismiss for failure to state a claim upon which relief could be granted, holding that the alleged violation of rule 10b-5 did not occur "in connection with the purchase or sale of any security" as required by the rule, since neither

[6] Securities Exchange Act of 1934 § 10, 15 U.S.C. § 78j (1964), reads in part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

[7] SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1968), provides:

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

[8] In addition to plaintiffs' rule 10b-5 cause of action at issue in this case, plaintiffs also alleged that defendants had violated section 18(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78r(a) (1964), which provides:

> Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement provided in subsection (d) of section 78o of this title, which statement was at the time and in light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction . . . .

Plaintiffs contended that Belock's annual report and the "10K Report" (a detailed document similar to an annual report), which were submitted by Belock to the SEC, constituted "filed" documents within the meaning of section 18(a). The court of appeals in *Heit* upheld the lower court decision that the copies of the annual report submitted to the SEC were not "filed" documents within section 18(a). See SEC Rule 14a-3(c), 17 C.F.R. § 240.14a-3(c) (1968). But the court did rule that the "10K Report" was a "filed" document within section 18(a) and remanded this point on the question of reliance. 402 F.2d at 914-17.

the corporation nor its "insiders" used the fraud for their own benefit.[9] The Court of Appeals for the Second Circuit held that plaintiffs did have a sufficient cause of action under rule 10b-5, and reversed and remanded the case for trial on the merits. In so holding, the court of appeals adopted the same broad interpretation of rule 10b-5 in private actions for damages that it used in the recent decision of *SEC v. Texas Gulf Sulphur Co.*,[10] which was primarily an SEC enforcement proceeding. The implications of *Texas Gulf Sulphur* have already elicited a voluminous literature,[11] yet *Heit* may have even greater implications for the business community.

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[9] Heit v. Weitzen, 260 F. Supp. 598 (S.D.N.Y. 1966); Howard v. Levine, 262 F. Supp. 643 (S.D.N.Y. 1965).

[10] 401 F.2d 833 (2d Cir. 1968), *rev'g and aff'g in part* 258 F. Supp. 262 (S.D.N.Y. 1966). Because this case bears directly on *Heit*, it is essential to set out some pertinent facts and part of the court's holding. In October, 1963, officials of the Texas Gulf Sulphur Company began exploring for ore on the Canadian Shield near Timmins, Ontario. Early results were extremely encouraging and further sampling continued until April, 1964. Between October, 1963, and April, 1964, certain persons associated with the company bought large quantities of the company's stock in the open market. However, no disclosure of the discovery was made until April 12, 1964, when the company issued a press release that confirmed that the company was exploring the area but that results were uncertain. Yet on April 16, 1964, just four days later, the company made full disclosure of a huge discovery. During that four day period, certain "insiders" continued to purchase stock.

As a result of these actions, the SEC brought an action against the company and the individual "insiders." The SEC sought an injunction against the company on the grounds that the company's press release of April 12, 1964, was deceptive and sought rescission of the transactions by the alleged "insiders." The district court held substantially for the defendants. SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1966). On the issue of the press release, the district court ruled that the April 12 release did not violate rule 10b-5 because it was not issued for the purpose of benefiting the corporation. The court also noted that there was no evidence that any "insider" used the release to his personal advantage. Furthermore, the district court did not feel the release was really misleading, based on the facts known at the time by the company. *Id.* at 292-96. In reversing the decision of the trial court, the court of appeals held that the true test was whether the release was misleading to the reasonable investor, regardless of whether the issuance of the release was motivated by corporate officers for ulterior purposes, and remanded the case on this point. 401 F.2d at 857-64. In so holding, the court gave rule 10b-5 a very broad construction and the references hereinafter to the *Texas Gulf Sulphur* case are to the language of the court on this point. As a result of this decision, there are now over one hundred suits pending in the Southern District of New York by private investors against the company and its officers for violations of rule 10b-5.

[11] For discussions of the district court case, see, *e.g.*, Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 VA. L. REV. 1271 (1965); Kennedy & Wander, *Texas Gulf Sulphur, A Most Unusual Case*, 20 BUS. LAW. 1057 (1965); Ruder, *Corporate Disclosures Required by the Federal Securities Laws: The Codification Implica-*

Since rule 10b-5 was promulgated in 1942 by the SEC, its use has greatly expanded to cover many different types of securities fraud.[12] The most prevalent application of the rule is in cases where two parties are dealing "directly"[13] with each other, *i.e.*, each party knows with whom he is dealing.[14] For example, a common rule 10b-5 case involves fraud in the sale of securities in a close corporation from one party to another. Originally, the only remedy under rule 10b-5 was injunctive relief in an SEC enforcement proceeding. Later, however, an implied civil action for damages developed to compensate investors for their losses.[15]

Open-market transactions are "indirect" and "impersonal"[16] in the sense that the parties to a transaction are usually unknown to each other and their communication is through some impersonal media. For this reason, Congress and the SEC have developed an articulated policy of keeping the market informed and free of manipulation. This is reflected in the fact that Congress, the SEC, and the major market institutions require prompt release of earnings and other significant developments by publicly traded corporations.[17] Moreover, the SEC has the broad power to suspend trading in any security when it feels the information available about a security is unreliable.[18]

Yet the impersonal nature of the open-market transaction has delayed the development of remedies in the form of private civil actions for damages under rule 10b-5. The rule expressly requires that a violation

tions of Texas Gulf Sulphur, 61 NW. U.L. REV. 872 (1967). For discussion of the recent court of appeals decision, see Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 NW. U.L. REV. 423 (1968) [hereinafter cited as Ruder]; Comment, *Securities Regulation: SEC v. Texas Gulf Sulphur*, 44 NOTRE DAME LAW. 252 (1968); Comment, *Insider Share Trading—Trading Without Disclosure of Prospective Mine Held to Violate Rule 10b-5*, 14 VILL. L. REV. 140 (1968).

[12] For background in the area covered by this note, see 3 L. Loss, SECURITIES REGULATION 1757-97 (2d ed. 1961). For an excellent analysis of rule 10b-5, see A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10B-5 (1967) [hereinafter cited as BROMBERG]. See also Comment, *Fraud in Securities Transactions and Rule 10b-5—A Survey of Selected Current Problems*, 46 N.C.L. REV. 599 (1968).

[13] The terms "direct," "indirect," and "impersonal" are part of the Bromberg classification of rule 10b-5 cases. See BROMBERG § 3.1, at 62.

[14] *Id.* §§ 4.1-6.5.

[15] *Id.* §§ 2.4(1)-(2).

[16] *Id.* §§ 7.1-.4.

[17] *E.g.*, Securities Exchange Act of 1934 § 13, 15 U.S.C. § 78m (1964).

[18] *Id.* § 19(a)(4), 15 U.S.C. 78s(a)(4) (1964) (exchange); *id.* § 15(c)(5), 15 U.S.C. § 78o(c)(3) (over-the-counter). The SEC suspended trading in Belock securities on June 22, 1965, when the irregularities involved in this case came to light. Trading was resumed November 9, 1965. Brief for Appellee at 12, Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968).

occur "in connection with the purchase or sale of any security." Courts initially interpreted this clause narrowly, thus restricting the application of the rule. First, they adopted the common law notion of fraud, by holding that the "in connection with" clause required that privity of contract exist between the defrauded party and the defendant.[19] Conceivably, the privity requirement could have prevented any application of the rule to open-market transactions since one who buys or sells rarely, if ever, knows the party on the other side of the transaction. The privity requirement, however, has begun to disappear, first in SEC enforcement proceedings, and now in private actions, as courts have realized that the rule has to be relaxed in order to protect the public in the expanding securities market.[20] Despite the trend away from requiring privity, the issue is still debatable as both sides in *Heit* felt compelled to argue the point in their briefs.[21]

In addition to the privity requirement, other restrictions have grown up around the "in connection with" clause to hinder the rule 10b-5 plaintiff. One of these restrictions deals with the defendant's state of mind. In *Heit* the facts indicated that the "purpose" of the fraudulent reports by Belock and its directors was not to inflate the market price of the stock but rather to conceal certain fraudulent overcharges from the government.[22] Both trial court decisions relied heavily on this point in their dismissals. In *Howard v. Levine*,[23] District Judge Cooper held that one of the prime defects in plaintiff's cause of action was that "[w]hatever fraud is alleged here . . . is directed against the government, notwith-

[19] See Comment, *Fraud in Securities Transactions and Rule 10b-5—A Survey of Selected Current Problems*, 46 N.C.L. REV. 599, 601-02 (1968).

[20] See BROMBERG §§ 2.5(3), 8.5.

[21] Brief for Appellants at 14-26, Brief for Appellees at 17-23, Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968). Apparently, the parties argued the privity requirement because an earlier Second Circuit case had dismissed a rule 10b-5 complaint when plaintiff failed to allege "[a] semblance of privity between the vendor and purchaser of the security." Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701, 706 (S.D.N.Y. 1951), *aff'd per curiam*, 198 F.2d 883 (2d Cir. 1952). Some courts have rejected *Farnsworth*. *See, e.g.*, Miller v. Bargain City, U.S.A., Inc., 229 F. Supp. 33, 37 (E.D. Pa. 1964); Freed v. Szabo Food Serv., Inc., [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,317 (N.D. Ill. 1964). Several recent decisions in the Second Circuit seem to reject it. New Park Mining Co. v. Cranmer, 225 F. Supp. 261 (S.D.N.Y. 1963); Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962). A 1967 Second Circuit case, Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967), casts grave doubt on it, and *Heit* seems completely to overrule it.

[22] 402 F.2d at 913. See note 3 *supra*.

[23] 262 F. Supp. 643 (S.D.N.Y. 1965).

standing its possible incidental market impact."[24] Similarly, District Judge Sugarman in *Heit v. Weitzen*[25] stated:

> The fraud against the Government in overcharging it on the contract having been already accomplished, the concealment thereof from the filed statements was for the purpose of further defrauding the Government by not disclosing the original malfeasance and not for the purpose of perpetrating a "misrepresentation or fraudulent practice usually associated with the sale or purchase of securities."[26]

Thus the trial courts agreed with defendants that the alleged violation could not have been "in connection with the purchase or sale of any security" because the fraud was not aimed at the market.

The court of appeals, however, relying on its recent decision in *SEC v. Texas Gulf Sulphur Co.*,[27] construed the "in connection with" requirement broadly and carried over the *Texas Gulf Sulphur* holding that the clause was satisfied whenever a device was employed " ' of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities.' "[28] Although *Texas Gulf Sulphur* was primarily an SEC enforcement proceeding, the *Heit* court showed no reluctance in carrying over the same rule to private actions for damages:

> "Rule 10b-5 is violated whenever assertions are made . . . in a manner reasonably calculated to influence the investing public, e.g., by means of the financial media . . . if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes."[29]

The court concluded by saying:

> It is reasonable to assume that investors may very well rely on the material contained in false corporate financial statements which have been disseminated in the market place, and in so relying may subsequently purchase securities of the corporation. The "ulterior motive" present in the instant case—the concealment of the fraud from the government—is irrelevant, since the false information was circulated

[24] *Id.* at 645.
[25] 260 F. Supp. 598 (S.D.N.Y. 1966).
[26] *Id.* at 602.
[27] 401 F.2d 833 (2d Cir. 1968).
[28] 402 F.2d at 913, *quoting from* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 860 (2d Cir. 1968).
[29] 402 F.2d at 913, *quoting from* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 862 (2d Cir. 1968).

> to a large segment of the investing public. It is impossible to isolate the particular "fraudulent" acts and consider them as directed toward the government alone.[30]

The court seems to be saying that although a much clearer case could be made out under rule 10b-5 if it could be shown that defendants' actions were "deliberate," *i.e.*, with an intent to injure, the rule is still satisfied if defendants' state of mind can be termed "knowing," *i.e.*, with knowledge that others will be misled even though there is no intent to injure.[31] This holding appears clearly justified[32] in light of the stated policy of rule 10b-5 to protect the innocent investor and furthermore accords with the common law concept that the law presumes every man to intend the natural consequences of his acts,[33] even though his true "motive" is different.

A third problem in the case, in addition to that of privity and state of mind, was that at no time did the corporation or any of its "insiders" trade in the securities or in any way seek to benefit from the alleged fraud in the market. For this reason, defendants contended that the rule 10b-5 requirement that a violation occur "in connection with the purchase or sale of any security" could never be satisfied where the defendants take no action whatsoever to benefit from the fraud.[34] The district courts agreed with defendants and relied on this point as one basis for the dismissal of plaintiffs' cases.[35] Again, however, the court of appeals disagreed with the district courts, relying on *Texas Gulf Sulphur*, and held that "[t]here is no necessity for contemporaneous trading in securities by insiders or by the corporation itself"[36] in order to satisfy the "in connection with" clause.

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[30] 402 F.2d at 913.

[31] There are actually five classifications commonly used to describe defendant's state of mind: deliberate, knowing, reckless, negligent, and innocent. See Ruder 436-37.

[32] *Cf. id.* at 441-42.

[33] Claflin v. Commonwealth Ins. Co., 110 U.S. 81, 95 (1884). Indications are that the Supreme Court would probably agree. In SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963), the Court, in interpreting the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (1964), said it would defeat the manifest purpose of that Act to "require proof of intent to injure." 375 U.S. at 195. Moreover, since the common law recognizes this form of intent, it is doubtful that courts would interpret rule 10b-5 to be more strict. Royal Air Prop., Inc. v. Smith, 312 F.2d 210, 212 (9th Cir. 1962).

[34] Brief for Appellee at 17-23, Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968).

[35] Heit v. Weitzen, 260 F. Supp. 598, 602 (S.D.N.Y. 1966); Howard v. Levine, 262 F. Supp. 643, 645 (S.D.N.Y. 1965).

[36] 402 F.2d at 913.

In most rule 10b-5 cases, the requirements of the "in connection with" clause are met because the parties are in privity. It is in a non-privity context that the clause poses problems. The holding in *Heit* that there is no necessity for contemporaneous trading in securities by insiders or the corporation constitutes the broadest interpretation yet in a non-privity case of the "in connection with" clause. Although this same interpretation was used by the same court in *Texas Gulf Sulphur*, that case as pointed out was only an SEC enforcement proceeding and obviously there was speculation as to whether the *Texas Gulf Sulphur* interpretation would be, or should be, carried over to private actions.[37]

Perhaps the broadest interpretation of the "in connection with" clause in a non-privity context before *Texas Gulf Sulphur* and *Heit* came in the fairly recent open-market case, *Freed v. Szabo Food Service, Inc.*[38] In *Freed*, management of a widely held over-the-counter firm made a false prediction as to the combined earnings of it and a privately held company with whom it proposed to merge. By the use of this false prediction of earnings, management hoped to induce shareholder approval of the proposed merger. Apparently, management's predictions were so optimistic that the price of the company's stock doubled in two and one-half months. Plaintiffs, who were open-market purchasers during that period, sued the company after its annual report revealed that actual earnings were only half of the prediction and plaintiffs had sold their shares at substantial losses.

In sustaining plaintiff's claim against a motion to dismiss, the court apparently felt that the "in connection with" clause was satisfied, despite the absence of corporate or insider trading, because management had issued the false report in order to facilitate shareholder approval of the pending merger.[39] Thus, in *Freed* the fraud was at least aimed at the market and management did use the scheme to benefit it in a stock-related venture. *Heit*, however, carries the *Freed* interpretation one step further, because the scheme was aimed at the government, not the shareholders.

What the court in *Heit* ultimately had to decide was exactly to whom the "in connection with" clause applied. Before *Heit*, the clause had been universally applied by courts to rule 10b-5 plaintiffs in civil cases, *i.e.*, the courts had interpreted "in connection with the purchase or sale of any

[37] *E.g.*, Ruder 423.

[38] [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,317 (N.D. Ill. 1964).

[39] BROMBERG § 7.2(2), at 150.

security" to mean that a rule 10b-5 plaintiff in civil cases must be a purchaser or seller of securities.[40] *Heit* continues this interpretation. But the primary question raised in *Heit* was whether the clause also applies to a rule 10b-5 defendant—more specifically, must defendant have traded in securities with the plaintiff or at least with a third party? The court held that the fundamental policy behind rule 10b-5, to protect investors, required a rule in which only plaintiff need be involved in a securities transaction. Otherwise, a corporate defendant would be immune from liability for false statements that caused damage as long as it did not trade in securities.

Heit raises difficult and what could be termed frightening questions. The reaction in the business community to its immediate predecessor, *Texas Gulf Sulphur*, was one of great alarm.[41] Needless to say, in carrying over the *Texas Gulf Sulphur* tests to private actions, *Heit* will create even more fear in corporate board rooms. The critical questions at this point are whether *Heit* was correctly decided, and, if so, should it be extended to cover other situations.

In order to make any decisions on these issues, it is important to isolate the factors that should be considered in determining liability under rule 10b-5.[42] Three factors appear throughout the decisions under rule 10b-5—the relation of the parties (privity versus no privity), the state of defendant's mind, and the general policies behind rule 10b-5. All of these factors have been thoroughly discussed and debated by writers as they were in *Heit*. One factor, however, seems to be of critical importance and yet receives very little attention in the reported decisions—the amount of damages a defendant would have to pay if he were held liable under rule 10b-5.[43] Apparently, one reason for this omission is that most reported decisions under rule 10b-5 discuss only whether there is a cause of action and do not reach the remedy issue. In fact, most rule 10b-5

[40] See Comment, *Fraud in Securities Transactions and Rule 10b-5—A Survey of Selected Current Problems*, 46 N.C.L. REV. 599, 601-05 (1968), pointing out the problems in defining purchaser or seller.

[41] The Wall Street Journal, August 29, 1968, at 1, col. 1.

[42] *E.g.*, Comment, *Negligent Misrepresentations under Rule 10b-5*, 32 U. CHI. L. REV. 824 (1965); Comment, *Civil Liability under Section 10B and Rule 10B-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658 (1965). For an excellent analysis of potential liability under rule 10b-5, see Ruder, *supra* note 9. He uses a classification based on several factors: privity versus nonprivity, misrepresentation versus nondisclosure, and state of mind (deliberate, knowing, reckless, negligent, or innocent). The conclusions drawn hereinafter in the text are in substantial agreement with the Ruder analysis.

[43] Ruder 427.

cases do not reach trial on the merits, but are settled out of court.[44] This policy of defendants to avoid the remedy issue may be a tactical error because a court fully apprised of the potential liabilities of a defendant might take a different view of the case. It is difficult, however, to estimate what the liability of the Belock Instrument Corporation or Texas Gulf Sulphur Company would be. However, some estimates are available on the Texas Gulf Sulphur Company. Assuming a rescission measure of damages for all those who sold their stock during the fraudulent period,[45] Texas Gulf Sulphur's liability to private investors could range as high as 390 million dollars, some 150 million dollars greater than the company's net worth.[46] Although Texas Gulf Sulphur's liability may be

[44] BROMBERG § 1.3(2).

[45] The issue of damages is one of the most perplexing problems surrounding rule 10b-5 violations in the open market. In a trial on the merits, plaintiff must prove that defendant's conduct *caused* his losses. Because of the multiple factors that can influence the market, causation is often hard to determine. For example, the court of appeals in *Texas Gulf Sulphur* admitted that the evidence as to the effect of the press release on the investing public was equivocal and less than abundant. 401 F.2d at 846.

The nature of the remedy is further complicated by the impersonal nature of the open market. If a corporation issues false information that is misleadingly pessimistic and that enables insiders to buy stock from defrauded sellers, almost all would agree that the profits of the insiders should be returned. Insider profits, however, will never equal the total loss of all sellers unless insiders were the only buyers in the market at the time of the fraud. In most cases, there are likely to be many innocent buyers in the market who reap a windfall gain by purchasing the security at less than its intrinsic worth. Of course, all losses by sellers would be windfall gains to innocent buyers in cases similar to *Heit* where neither the corporation nor its insiders trade in the securities.

One solution to this problem would be to find out exactly who sold to the insiders as a result of the fraud and rescind the transactions. Yet this solution is less than satisfactory. As pointed out, it is not the transactions of the insiders that cause losses to investors, but rather the misrepresentations. Those who sell in the open market and wind up in unwitting privity with the insiders should not have a stronger claim for recovery than all the other investors who sold during the period. The only solution is to hold the defendant liable for the losses of all sellers, regardless of whether there was insider trading.

The final question that remains is the appropriate measure of damages. At least two theories are feasible. One theory, the out-of-pocket theory, would award the defrauded seller the difference between what he received for the stock at the time of sale and its intrinsic worth at the time. The second theory, a rescission measure of damages, would produce higher damages, as the measure is the difference between the sale price and the value of the stock when the fraud is remedied. In privity situations, the trend has been toward a rescission measure of damages. *See* Baumel v. Rosen, 283 F. Supp. 128 (D. Md. 1968). Because of the potential liability, there would seem to be good reasons to limit open-market, non-privity liability to an out-of-pocket measure. For a more thorough discussion of this issue, see BROMBERG § 8.7, at 213-20; Ruder 427-29.

[46] Ruder 427-29.

substantially greater than Belock's would be because Texas Gulf Sulphur's stock went from thirty dollars a share to an amazing one hundred and sixty dollars a share during the alleged fraud,[47] Belock still has a large potential liability. For this reason, the amount of damages should be a critical factor in determining ultimate liability under rule 10b-5.

Taking into account all four factors in *Heit,* the decision appears to be correct. Few would disagree that privity, as in other fields, must not be strictly required in open-market transactions if investors are to be adequately protected. Regarding defendant's state of mind, the holding of the court as to "knowing" violations is justified to deter wilful acts of misconduct, and it is unimportant whether defendants engaged in transactions at the time of the alleged violation because it was the misrepresentation of defendants, not their transactions, which caused the plaintiffs' loss.[48] The general policy behind the rule and the undesirable consequences of immunity for a corporation under these circumstances dictate liability despite the magnitude of the potential liability.

Under similar facts, however, liability should not extend to negligent misrepresentation by the corporation.[49] In *Texas Gulf Sulphur,* the court held that proof of negligence was sufficient to sustain an action for injunctive relief under rule 10b-5(b), but at the same time found it unnecessary to decide whether negligence would suffice in a private suit for damages.[50] Judge Friendly, however, in his concurring opinion intimated that the appropriate standard in a private suit should embody a scienter requirement.[51] In *Heit,* the court again did not reach the issue.[52]

There are several reasons why the line should be drawn at intentional conduct. First, the potential damages, as pointed out above, are immense. Furthermore, it would not further the goal of deterrence to any great extent to hold the defendant liable for negligence. Finally, and perhaps most importantly, if a corporation is held liable for negligent misrepresentations when it has no intent to harm, it will simply not say anything rather than risk the possibility of liability. This silence will defeat the primary purpose of rule 10b-5—a continuous flow of information for the

[47] *Id.*

[48] BROMBERG § 8.7(2), at 217; Ruder 442.

[49] Ruder 442.

[50] 401 F.2d at 863.

[51] *Id.* at 864-69.

[52] "The question is troublesome . . . . There is no occasion for us to enter this legal thicket as we pass only upon the legal sufficiency of the complaints to allege a claim for relief." 402 F.2d at 913-14. The court held that plaintiffs' alternative pleading of intent or negligence was sufficient to sustain the complaint. *Id.* at 914.

investor. Of course, this last observation raises the intriguing question as to whether a corporation not in privity, which is not engaging in securities transactions, can be liable under rule 10b-5 for deliberate and knowing nondisclosure. The answer would seem to be no.[53]

A final factor to be considered in any decision concerning corporate liability is the question of who in the corporation will bear the ultimate burden of the liability. Conceivably, the ultimate burden may fall on innocent shareholders of the corporate defendant when the corporation has to pay these awards. It is unlikely that management will be tagged with the ultimate burden, and this should be an important consideration in formulating an appropriate remedy.[54]

Thus, *Heit* and *Texas Gulf Sulphur* raise some very crucial questions. Counsel for defendants in *Heit* have filed a petition for certiorari to the Supreme Court.[55] Although the Supreme Court has never spoken directly on rule 10b-5, its general remarks in the securities field have been pro-investor.[56] Because of the implications of these cases, it is important for Congress or the Court to speak soon.

Assuming that Congress does not act, it is interesting to speculate as to what the Supreme Court might do with this problem. It would seem that an analogy[57] could be drawn between the problem in *Heit* and the problem the Court faced in *New York Times v. Sullivan*.[58] In *Sullivan*, the Court used "definitional balancing"[59] to reconcile the state libel laws

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[53] [W]here the violation is nondisclosure, the defendant's duty to disclose arises from the "inherent unfairness involved where a party takes advantage of such information." . . . . Since the non-trading, nondisclosing defendant has not taken advantage of the information, it can hardly be said that he has violated his duty, for that duty is said to arise from his use of inside information when it is unfair for him to do so.

Ruder 442.

[54] Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340, 1370 (1967); *Symposium—Rule 10b-5: Developments in the Law*, 63 NW. U.L. REV. 523 (1968).

[55] 37 U.S.L.W. 3250 (U.S. Jan. 2, 1969) (No. 894).

[56] *See, e.g.*, SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963). The Court held that the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (1964), "like other securities legislation 'enacted for the purpose of avoiding fraud,'" must be construed "not technically and restrictively but flexibly to effectuate its remedial purposes." 375 U.S. at 195. "The broad policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." SEC v. W. J. Howey Co., 328 U.S. 293, 301 (1946) (interpreting Securities Act of 1933 § 2(1), 15 U.S.C. § 77b(1) (1964)).

[57] See Comment, *Securities Regulation: SEC v. Texas Gulf Sulphur*, 44 NOTRE DAME LAW. 252, 262-63 (1968).

[58] 376 U.S. 254 (1964).

[59] See Nimmer, *The Right to Speak from* Time *to* Time: *First Amendment Theory Applied to Libel and Misapplied to Privacy*, 56 CALIF. L. REV. 935 (1968).

and the first amendment right of free speech with regard to public officials. The Court held the standard to be one of actual malice, that is, knowledge that a statement is false or with reckless disregard of whether it was false or not. Of course *Heit* is distinguishable in many respects, primarily because Congress could presumably legislate a negligence standard if it so desired without running afoul of the Constitution. Absent congressional action, however, and in view of the competing policy goals—preventing fraud without interfering with the flow of corporate information—the *Sullivan* line would be an appropriate resolution of the matter. Until then, sales of corporate executives' liability insurance will probably continue to soar.[60]

RALEIGH A. SHOEMAKER

Securities Regulation—In Pari Delicto as a Defense for a Violation of Rule 10b-5

In *Kuehnert v. Texstar Corp.*,[1] the plaintiff had become acquainted through business dealings with the defendant, president of Texstar, and a personal friendship had soon developed. Over a period of five months, the defendant continuously supplied the plaintiff with inside information consisting of assurances of increased stock dividends and proposed profitable business dealings with two major oil companies. Relying primarily on this confidential information,[2] the plaintiff began buying Texstar stock on margin on the open market. None of the value-enhancing occurrences ever materialized, and the plaintiff was forced to sell his stock and suffered a large financial loss.[3] The federal district court held that the plaintiff was a tippee under Securities Exchange Commission Rule 10b-5,[4] and denied

[60] *Symposium—Rule 10b-5: Developments in the Law*, 63 NW. U.L. REV. 544 (1968) (suggesting that no insurance be allowed corporate executives for intentional or negligent violations of rule 10b-5).

[1] 286 F. Supp. 340 (S.D. Tex. 1968). On May 9, 1969, the United States Court of Appeals for the Fifth Circuit affirmed by a 2-1 decision. — F.2d — (1969).

[2] Apparently, another reason for Kuehnert's purchases was to help defendant retain the presidency of the company. Brief for Appellee at 5-9, Kuehnert v. Texstar Corp., — F.2d — (5th Cir. 1969).

[3] 286 F. Supp. at 342-43.

[4] 17 C.F.R. § 240.10b-5 (1968):

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of a material fact or to omit to state a

him relief because of his knowledge that he was using inside information.[5]

When a tippee is a party to the action, he is normally the defendant. He usually receives information from an insider that is not available to the general investing public and uses this information to purchase or sell stock, either directly from a third party,[6] or indirectly on the open market.[7] The stock then increases or decreases in value as expected by the tippee, and he in turn is sued by the third party who suffered a loss because of this transaction. The instant case differs from this normal situation in at least two respects: the inside information received by Kuehnert was false, and this false information led to substantial losses, placing the tippee in the position of a plaintiff.

In holding that the plaintiff, as a tippee, could not recover under Rule 10b-5, the court stated that the Rule

> cannot be used by such a person to sustain a cause of action for fraud. It is the ordinary person that buys and sells securities based upon information generally available to the investing public who is protected by Section 78j(b) of the Act and Rule 10b-5 and not one that has access to or believes he has access to secret, material, confidential, corporate information.[8]

This language would seem to preclude recovery under the Rule by anyone that has participated in insider trading regardless of the validity of the information.[9] Yet, denying recovery to the tippee who has lost money

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material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Rule 10b-5 was promulgated pursuant to section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78 (1964), which provides that

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

[5] 286 F. Supp. at 345.

[6] *E.g.*, Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967).

[7] *E.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

[8] 286 F. Supp. at 345.

[9] It was also argued that because the information was false, it would constitute a violation of the rule for the tippee to disseminate it to the general public. Brief for Appellant at 5, Kuehnert v. Texstar Corp., — F.2d — (5th Cir. 1969).

in a transaction induced by an insider is seemingly inconsistent with the trend of imposing civil liability under Rule 10b-5 whenever any false information given concerning the financial situation of a corporation results in a loss to the purchaser who relied on this information. In conjunction with potential criminal sanctions and administrative regulations, the use of Rule 10b-5 to impose civil liability[10] on insiders for violation of the Rule provides an additional deterrent to fraudulent practices in security transactions.[11] The holding in this case may thus lessen the deterrent effect of the Rule by relieving many defendant-insiders from such liability. This seems particularly true in light of the growing class of persons who may be considered "tippees."[12] Under the *Kuehnert* language, insiders could disseminate false information with relative impunity, for whatever reason, to the large class of traders who are tippees.

The imposition of civil liability under 10b-5 requires three elements in order to establish a right of recovery, all of which seem to be present in this case: 1) a purchase by the plaintiff, 2) reliance on misleading statements made by the defendant, and 3) a financial loss suffered through this purchase.[13] It seems clear, then, that Kuehnert would have been allowed to recover, absent the defense permitted by the court. The reason for denying recovery was unclear, but the court did use the doctrine of in pari delicto[14] as an alternative holding.[15] Although the doctrine was mentioned only briefly in the opinion, its rationale permeates the entire decision. For example, the court stated that "the tippee such as Kuehnert must be painted with the same brush and the same color as the insider from whom the tippee receives his information,"[16] and that "Rule 10b-5 [was]

[10] The first instance in which civil liability was imposed under Rule 10b-5 was Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). There have, apparently, been no subsequent decisions rejecting this innovation, and it has met with overwhelming acceptance. Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 676 (N.D. Ind. 1966). *See also* Ruder, *Corporate Disclosures Required by the Federal Securities Laws: The Codification Implications of Texas Gulf Sulphur*, 61 Nw. U.L. Rev. 872 (1967).

[11] See Fratt v. Robinson, 203 F.2d 627, 632 (9th Cir. 1953): "[N]othing . . . would tend more . . . to deter fraudulent practices in security transactions . . . than the right of defrauded sellers or buyers . . . to seek redress in damages in federal courts."

[12] *See* A. Bromberg, Securities Law: Fraud § 4.4, at 76 & n.33.1 (1967).

[13] Posner, *Developments in Federal Securities Regulation*, 22 Bus. Law. 645, 654 (1967).

[14] For different applications of this doctrine, *compare* Hall v. Corcoran, 107 Mass. 251 (1871), *with* Whelden v. Chappel, 8 R.I. 230 (1865).

[15] "Alternatively, the defense of in pari delicto asserted by the defendants is good as against Kuehnert, although because of the above holding no further discussion of that doctrine and its applicability here is necessary." 286 F. Supp. at 345.

[16] *Id.*

not intended to be and cannot be used by such a person to sustain a cause of action for fraud."[17] These passages seem to reiterate the policy of the in pari delicto doctrine—that someone who is at fault will be precluded from recovery from another party at fault, even if the other party may be more blameworthy.[18]

In using this language, the court may have felt that if the plaintiff himself were found to be a violator of the Rule, denying him recovery might be an effective deterrent to people who find themselves in the position of the tippee in the future. Since there could be no possibility of recovery from anyone in the event the insider information was incorrect, the tippee would theoretically refrain from trading on any inside information. Another possibility left open by the court's language is that a balancing test could be used to determine whether a particular tippee would be allowed to recover based on the comparative guilt in each individual case. But the judicial imposition of civil liability under the Rule has eliminated the necessity of proving all the required elements[19] of common law fraud,[20] and it is arguable that to preserve the overall deterrent effect of permitting civil recovery under Rule 10b-5, the Rule should also preclude the equitable defense of in pari delicto under any circumstances.

Traditionally the concepts inherent in in pari delicto were used in litigation involving private parties, where public regulation was not involved. When private litigants have been given a significant role in furthering public aims, as is evidenced by the civil remedy in connection with criminal sanctions for a violation of the Securities Exchange Act, sound arguments exist for limiting the scope of equitable defenses.[21] An illustrative analogy[22] is found in recent antitrust litigation.[23] The Supreme Court of the United States eliminated the doctrine of in pari delicto as a

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[17] *Id.*

[18] See, *e.g.*, Note, *In Pari Delicto and Consent as Defenses in Private Antitrust Suits*, 78 HARV. L. REV. 1241 (1965).

[19] The common law elements of fraud are: (1) a false representatation, (2) of a material fact, (3) made with knowledge of its falsity, and (4) with intent to deceive, (5) which representation is relied upon by plaintiff, (6) resulting in damage to him. W. PROSSER, LAW OF TORTS §§ 100, 104, at 700, 736 (3d ed. 1964).

[20] *E.g.*, Speed v. Transamerica Corp., 99 F. Supp. 808, 831 (D. Del. 1951).

[21] *Cf.* Note, *In Pari Delicto and Consent as Defenses in Private Antitrust Suits*, 78 HARV. L. REV. 1241, 1241-42 (1965).

[22] The following analogy has been drawn between these two fields. "Private enforcement of the proxy rules provides a necessary supplement to Commission action. As in antitrust treble damage litigation, the possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement of the proxy requirements." J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964).

[23] Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134 (1968).

defense to a civil action for an antitrust violation under both Section 1 of the Sherman Act[24] and Section 3 of the Clayton Act.[25] The court concluded that the public policy of permitting civil recovery as an additional deterrent for a violation of the antitrust laws was paramount to the equitable doctrine of in pari delicto.

It would appear also that the overriding interest of maintaining the integrity of the securities exchange can probably be best achieved by preventing fraud at its source. Admittedly, an individual plaintiff may be allowed to recover when his actions have been just as blameworthy as the defendant's, but the limited number of situations in which the plaintiff might be equally blameworthy would not seem to justify the administrative costs and burdens of allowing the defendant to prove that the equities are in his favor in a particular case.

Permitting equitable defenses also appears inconsistent with developing trends of 10b-5 enforcement, and in fact with the purpose of the Rule itself, which was designed in large part to protect the integrity of stock transactions[26] by deterring the misconduct of insiders.[27] Judicial attempts to eliminate misconduct by facilitating recovery for a violation of the Rule are evidenced by the steady liberalizing of its requirements: the common law elements of fraud do not have to be proved,[28] the requirement of privity has been emasculated,[29] and the concept of who may qualify as an "insider" subject to the Rule is expanding.[30] These trends all serve to discourage securities fraud, and allowing equitable defenses for the initiator of the false information could serve to weaken any such deterrent effect. Further, by holding that the Rule was not intended to protect one "that has access to or believes he has access to secret, material, confidential, corporate information,"[31] the court arguably reads out that part of the Rule that states that "[i]t shall be unlawful for any person . . . to make any untrue statement . . . in connection with the purchase or

[24] 15 U.S.C. § 1 (1964).
[25] 15 U.S.C. § 14 (1964).
[26] Pettit v. American Stock Exch., 217 F. Supp. 21, 28 (S.D.N.Y. 1963).
[27] List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir. 1965).
[28] Posner, *Developments in Federal Securities Regulation*, 22 BUS. LAW. 645, 654 (1967).
[29] Ruder, *Corporate Disclosures Required by the Federal Securities Laws: The Codification Implications of Texas Gulf Sulphur*, 61 NW. U.L. REV. 872, 892-96 (1967).
[30] *E.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).
[31] 286 F. Supp. at 345.

sale of any security."[32] It seems unlikely that the court could have intended to weaken so substantially such a significant part of the Rule, but at least insofar as the civil remedy is concerned the effect of its language could have this result.

In denying the plaintiff the use of the Rule in this case, the court does not employ all the potential deterrent force it has available. All the court requires in order to bar a plaintiff from recovery under the Rule is that he believe that he is using some secret information.[33] A different result in this case would have the effect of reducing the number of initial false statements, and recovery would not be dependent on the later actions of the one who received the information. The subsequent action by the plaintiff does not lessen the evil of giving false statements in the first place, and should not relieve the defendant of any liability, either civil or criminal. In short, the subjective intent of the tippee should not lessen the responsibility of an instigator who has clearly violated the Act himself.

ALEXANDER P. SANDS, III

Torts—Liability of Builder-Vendor's Lender for Failure to Protect Vendee against Defective Home

In *Connor v. Great Western Savings and Loan Association*,[1] the California Supreme Court held that a lender who provided financing for a subdeveloper had a duty to purchasers to exercise reasonable care to prevent the builder from constructing and selling defective houses. The subdeveloper was inexperienced and undercapitalized, and its lender retained substantial control over the subdevelopment planning almost to the point of being an entrepreneur without sharing attendant risks. *Connor* is a decision without precedent,[2] and it pioneers a new area in a field that was already in a great state of flux—tort liability in the home-building in-

[32] 17 C.F.R. § 240.10b-5 (1968).
[33] 286 F. Supp. at 345.

[1] — Cal. 2d —, 447 P.2d 609, 73 Cal. Rptr. 369 (1968) (Traynor, C.J., in a 4-3 decision).

[2] The intermediate appellate court did reach almost the same result, however, in holding that Great Western owed purchasers of housing built by the subdeveloper a duty "at least to the extent of protecting these persons from gross structural hazards." Connor v. Conejo Valley Dev. Co., 253 Cal. App. 2d —, —, 61 Cal. Rptr. 333, 344 (Dist. Ct. App. 1967).

dustry.[3] Before the decision, California subscribed to the fast-developing majority view that builder-vendors are liable for their negligence to vendees and third parties who might foreseeably be injured by latent defects in home design and construction.[4] But at least three jurisdictions have gone further and have held building contractors strictly liable in tort for the sale of defective homes.[5]

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[3] *See* W. PROSSER, LAW OF TORTS, § 99, at 693-96 (3d ed. 1964) [hereinafter cited as PROSSER]; Bearman, *Caveat Emptor in Sales of Realty—Recent Assaults Upon the Rule*, 14 VAND. L. REV. 541 (1961); Brown, *Building Contractor's Liability After Completion and Acceptance*, 16 CLEV.-MAR. L. REV. 193 (1967); Note, *Torts —Recent Extensions in Builder-Vendor's Liability for Defects*, 47 N.C.L. REV. 236 (1968); Comment, *Liability of the Institutional Lender for Structural Defects in New Housing*, 35 U. CHI. L. REV. 739 (1968).

[4] Sabella v. Wisler, 59 Cal. 2d 21, 377 P.2d 889, 27 Cal. Rptr. 689 (1963); Dow v. Holly Mfg. Co., 49 Cal. 2d 720, 321 P.2d 736 (1958). *See* PROSSER § 99, at 695 & nn.80-84.

[5] State Stove Mfg. Co. v. Hodges, — Miss. —, 189 So. 2d 113, *cert. denied*, 386 U.S. 912 (1966) (Mississippi); Schipper v. Levitt & Sons, 44 N.J. 70, 207 A.2d 314 (1965) (New Jersey); Humber v. Morton, 426 S.W.2d 554 (Tex. 1968) (Texas). The Mississippi decision was based in part on the fact that a manufactured product—a water heater—caused the damage to the home. The court emphasized, however, that defendant contractors were held liable not only as retailers or wholesalers of the water heater but also as builders of the house in which it was installed. — Miss. at —, 189 So. 2d at 123. The New Jersey decision used some language that could be interpreted to mean a warranty liability rather than strict liability in tort. But in Rosenau v. City of New Brunswick, 51 N.J. 130, 238 A.2d 169 (1968), *modifying* 93 N.J. Super. 49, 224 A.2d 689 (Super. Ct. App. Div. 1966), the New Jersey Supreme Court emphasized that the statute of limitations and other sales warranty defenses are not applicable in tort suits against builder-vendors. Other jurisdictions have cited *Schipper* with approval or spoken of strict liability, but the fact situation and the language used implies more of a warranty liability theory than one of strict liability in tort. *E.g.*, F & S Const. Co. v. Berube, 322 F.2d 782 (10th Cir. 1963); Bethlahmy v. Bechtel, 91 Idaho 55, 415 P.2d 698 (1966); Jones v. Gatewood, 381 P.2d 158 (Okla. 1963); Waggoner v. Midwestern Dev. Co., — S.D. —, 154 N.W.2d 803 (1967); Haye v. Century Builders, 52 Wash. 2d 830, 329 P.2d 474 (1958).

After this case note went to press, Kriegler v. Eichler Homes, Inc., — Cal. App. 2d —, 74 Cal. Rptr. 749 (Dist. Ct. App. 1969) was handed down adding California to the jurisdictions that hold builder-vendors of defective homes strictly liable in tort for injuries to users of the homes and their property. Plaintiff homeowner brought an action for damages as a result of the failure of a heating system against the builder, a mass-producer of housing. Affirming a judgment in favor of the plaintiff, the court of appeal cited with approval Schipper v. Levitt & Sons, Inc., 44 N.J. 70, 207 A.2d 314 (1965). It observed that "in terms of today's society, there are no meaningful distinctions between Eichler's mass production and sale of homes and the mass production and sale of automobiles and . . . the pertinent overriding policy considerations are the same." — Cal. App. 2d at —, 74 Cal. Rptr. at 752. The court adopted the arguments made in *Schipper* that there is no real opportunity for the buyer effectively to inspect a house for defects and agreed that the builder-vendor is in the best position to bear the loss. Although the language of the court implies that strict tort liability for builder-vendors is

Connor could presage the application of strict liability to lenders who finance housing developers in those jurisdictions that hold builder-vendors strictly liable. This result would supplement favorably the policies behind holding builder-vendors liable for defective homes in cases where the lender retains a certain amount of control over the capital loaned. Arguably, the best policy result that will emerge from the disparity of liability law in the building field is that both builder-vendors, whether large or small, and their financial backers who retain any control over the project, whether one home or a subdevelopment, will be held strictly liable for any dangerously defective houses sold. With a substantial number of builder-vendors operating on such dangerously thin capitalization that plaintiffs with claims against them for defective homes may find it impossible to satisfy judgments,[6] the home-construction industry is an area in which vicarious liability can be extended to lenders for valid social policy reasons.

Concededly, *Connor* involved liability of the lender predicated upon some fault—negligence—and the holding is revolutionary in extending the duty of the lender who backs a financially weak contractor to the vendees of the houses constructed. Since builder-vendors in California are liable to third-party users of homes for negligence in design and construction, it is reasonable to assume that *Connor* also imposes a duty on lenders that runs to such third parties. But the fact situation and the policy reasons set forth by the majority are also important in an argument for extending strict liability to lenders.

The situation in *Connor* was as follows: defendant Great Western Savings & Loan agreed to supply funds necessary for two contractors doing business as the Conejo Development Company to purchase a one-hundred acre tract and to construct homes thereon. Upon investigating the developer's financial condition, Great Western learned that it was extremely weak—the builder-vendor having only $5,000 capital when it started its development plans.[7] Yet Great Western exercised less than normal care in making the loan and failed to examine the foundation plans, failed

limited to mass developers, these two basic arguments also can be applied to small builder-vendors of individual houses. See text p. 997 *infra*. Now that California has adopted strict tort liability for at least some classes of builder-vendors, the way has been cleared for holding their lenders strictly liable upon application of the criteria outlined p. 993 *infra*.

[6] Comment, *Liability of the Institutional Lender for Structural Defects in New Housing*, *supra* note 3, at 740.

[7] — Cal. 2d at —, 447 P.2d at 613, 73 Cal. Rptr. at 373.

to require soil tests, and failed "to discover gross structural defects that it could have discovered by reasonable inspection."[8] Plaintiffs in two actions consolidated for trial were home-buyers who suffered serious property damage when foundations ill-designed for the adobe soil cracked.

Chief Justice Traynor, in reversing the trial court's nonsuit in favor of defendant Great Western, first concluded that the lender's acts of omission were sufficient for a finding of a negligent breach of duty to its shareholders, to whom it owed a duty not to finance defectively-built homes since the value of security for the construction loans depended on sound construction.[9] But he also concluded that the lender was negligent in failing to take reasonable steps to prevent potential buyers from receiving defective homes and that it owed a duty of reasonable care to them.[10]

Of great significance to the holding of a duty extending to the buying public was the finding that Great Western exercised significant control over the project. It dictated the price of the homes and insisted on substantial fees in excess of ordinary interest for making the construction loan to Conejo. It also received an agreement from Conejo to protect it from lost profits in the event that home-buyers could not be persuaded to obtain their loans through Great Western. Thus, concluded the majority of the court, the risk of harm foreseeable to the plaintiffs because of Conejo's "dangerously thin capitalization" was increased "by the additional pressures on Conejo ensuing from its onerous burdens as a borrower from Great Western."[11]

Although California and most other jurisdictions have not yet accepted the theory of strict liability in tort for builder-vendors,[12] *Connor* made

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[8] *Id.* at —, 447 P.2d at 616, 73 Cal. Rptr. at 376.

[9] *Id.*

[10] *Id.* at —, 447 P.2d at 617-19, 73 Cal. Rptr. at 377-79. The policy reasons specifically set forth were that Great Western's transactions were intended to affect and did affect the plaintiffs to a significant degree; there was a foreseeable risk of harm to plaintiffs; the certain injury suffered by plaintiffs was closely connected with Great Western's negligent omissions; substantial moral blame attached to defendant; and the policy of tort law to prevent future harm called for extension of duty.

[11] *Id.* at —, 447 P.2d at 617, 73 Cal. Rptr. at 377.

[12] See note 5 *supra*. California has specifically refused to adopt the theory of strict liability in tort for builder-vendors. Conolley v. Bull, 258 Cal. App. 2d 749, 65 Cal. Rptr. 689 (Dist. Ct. App. 1968); Halliday v. Greene, 244 Cal. App. 2d 482, 53 Cal. Rptr. 267 (Dist. Ct. App. 1966). It is questionable, however, that the most important reason given for refusal—that a buyer of real property has an opportunity to inspect for defects—will withstand the language of the California Supreme Court in *Connor*. See text accompanying notes 17-18 *infra*. The other

most of the policy arguments that have been advanced for holding builder-vendors strictly liable for selling defective homes. These arguments generally have one underlying theory: the builder of a home should stand no differently in the law than manufacturers of chattels who, in an increasing number of jurisdictions,[13] are held strictly liable for defective products unreasonably dangerous to persons or property.[14] The same arguments for holding both the manufacturer of chattels and the builder of homes strictly liable follow quite logically. In *Santor v. A & M Karagheusian, Inc.*,[15] a recent case involving a suit against the manufacturer of an allegedly defective carpet, the New Jersey Supreme Court said,

> the great mass of the purchasing public has neither adequate knowledge nor sufficient opportunity to determine if articles bought or used are defective. Obviously they must rely upon the skill, care and reputation of the maker. . . . [W]hen the manufacturer presents his goods to the public for sale he accompanies them with a representation that they are suitable and safe for the intended use.[16]

Certainly the vast majority of the home-buying public also relies on the skill, care and reputation of the builder. And if an ordinary citizen is unable to tell whether carpeting, power tools, and the like are defective in a manner dangerous to persons or property, he is usually less able to detect defective conditions in the home he purchases. In *Connor*, Chief Justice Traynor pointed out that "the usual buyer of a home, [*sic*] is ill-equipped with experience or financial means to discern such structural

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reasons set forth by the two cases are also dubious. They suggest that a contractor-vendor is seldom in a position to limit liability by such devices as express warranties and disclaimers. However, chattel manufacturers, who are often held strictly liable, are not permitted by most courts to limit liability in these ways because to do so is considered unconscionable. *See, e.g.*, Henningsen v. Bloomfield Mtrs., Inc., 32 N.J. 358, 161 A.2d 69 (1960). The final reason for refusal to apply strict liability to builder-vendors is that an occupant of a building can more easily trace a defect to the negligence of the builder than a user of a chattel can trace a defect to the manufacturer. This argument fails to meet the primary economic purpose for the application of strict liability: The individual earning a profit from his products or structures should bear the risks of their being defective because he is the most effective risk-spreader.

[13] *See* PROSSER § 97, at 678-84.

[14] RESTATEMENT (SECOND) OF TORTS § 402A (1965).

[15] 44 N.J. 52, 207 A.2d 305 (1965).

[16] *Id.* at 64-65, 207 A.2d at 311. *Accord*, Greenman v. Yuba Power Prods., Inc., 59 Cal. 2d 57, 377 P.2d 897, 27 Cal. Rptr. 697 (1963). *Cf.* Seely v. White Motor Co., 63 Cal. 2d 9, 403 P.2d 145, 45 Cal. Rptr. 17 (1965), which approves holding manufacturers strictly liable in tort for personal injuries or property damage, but criticizes the result in *Santor* for allowing recovery for loss of bargain on the strict liability theory.

defects. . . . Moreover a home is not only a major investment for the usual buyer but also the only shelter he has. Hence it becomes doubly important to protect him against structural defects . . . ."[17]

The theory often used in the past by courts unwilling to hold builder-vendors liable even for negligence in construction after a buyer accepted the house was that he had an opportunity to inspect the house and should have rejected it if defective.[18] As a practical matter, however, it simply is not possible for the average home buyer to detect defects in the home that he is about to acquire; even an architect would generally be unable to discover a defective foundation.

Santor also based the strict liability of the manufacturer on the theory that it could best bear the expense of personal or property injuries sustained because of defects in a manufactured product, even if not caused by negligence of the defendant.[19] This risk-spreading theory may be extended by logical analogy to builders of homes.[20] They have the opportunity to insure or spread the risks through prices just as do manufacturers of chattels.

Chief Justice Traynor in *Connor* adopted the argument that prevention of future harm through the use of tort liability supported holding the lender liable to the home purchaser for negligence, for "[r]ules that tend to discourage misconduct are particularly appropriate when applied to an established industry."[21] The risk of tort liability may not prevent injuries in many areas such as automobile driving, but an established industry with the habit of considering all of the angles of profit and loss is apt, as the court's language suggests, to take greater care to protect the public if it knows it could face damage suits for failure to check and control its activities.[22] If strict tort liability is applied to builder-vendors and their financial backers, arguably they would exercise even more diligence to insure the safety of homes.

Courts, then, can rely on these basic reasons for the view that builder-vendors are strictly liable in tort: risk-spreading by the party most able to do so, the helplessness and disadvantage of the buyer, prevention of

[17] — Cal. 2d at —, 447 P.2d at 618, 73 Cal. Rptr. at 378. *Compare* Schipper v. Levitt & Sons, 44 N.J. 70, 91, 207 A.2d 314, 326 (1965) *and* Humber v. Morton, 426 S.W.2d 554, 561 (Tex. 1968).

[18] *See* PROSSER § 99, at 694.

[19] 44 N.J. at 65, 207 A.2d at 311-12.

[20] Schipper v. Levitt & Sons, 44 N.J. 70, 207 A.2d 314 (1965).

[21] — Cal. 2d at —, 447 P.2d at 618, 73 Cal. Rptr. at 378.

[22] This idea is also suggested in Brown, *supra* note 3, at 218.

future harm, and the general feeling that the party engaging in an enterprise for profit should bear the burden if something goes awry. *Connor* used the same reasons for holding that the lender had a duty extending to the home purchaser. It is arguable that California may reasonably adopt the policies underlying *Connor* to hold builder-vendors strictly liable. And with this foundation laid, California logically could go further and hold lenders in the situation of Great Western strictly liable for defects in houses sold by builder-vendors that they finance.

Such an ultimate extension can be supported by the language of the intermediate California appellate court in its treatment of *Connor*:[23]

> Since we recognize the obligation of the manufacturer who has the capacity to launch numerous potentially hazardous products on the market, should we not be prepared to impose similar standards of responsibility on the experienced and knowledgeable home-lending institution when it financially launches an untried developer by assisting him to produce and sell residential units to the uninformed public?[24]

All of the policy arguments for holding manufacturers and builders strictly liable for defects in what they produce can be applied with equal force to savings and loan associations, banks, and other lenders who back the home-construction industry. The lender is familiar with the entire transaction and, in all practicality, is the moving force behind most housing developments today.[25] Without the lender's money most builder-vendors could not carry out their projects. Because it controls the capital, the lender is in the best position to prevent fraud and defectively-designed or defectively-constructed housing.

Furthermore, lenders are better risk-bearers and risk-spreaders than are builders and subdevelopers. As the facts in *Connor* indicate, many of the builder-vendors in the residential construction field are undercapitalized and inexperienced; they are often insolvent or no longer in business by the time defects in their housing are discovered.[26] Thus contractors who build and sell homes, even if held strictly liable for defects that prove dangerous, will often be too irresponsible or too insolvent to

[23] Connor v. Conejo Valley Dev. Co., 253 Cal. App. 2d —, 61 Cal. Rptr. 333 (Dist. Ct. App. 1967).

[24] *Id.* at —, 61 Cal. Rptr. at 346.

[25] For a good summary of financing of the residential construction industry, see Comment, *Liability of the Institutional Lender for Structural Defects in New Housing, supra* note 3, at 741-48.

[26] *Id.* at 740.

have done anything, such as insuring, to spread the risks. Lenders, on the other hand, generally would tend to be more responsible and see that the risk is spread in at least two ways—by requiring the builder to insure or by charging the builder higher interest rates.[27]

Finally, extension of strict liability to lenders such as Great Western probably would enhance the possibility of preventing future harm from defective housing. Lenders logically would take greater precaution in approving development plans and in inspecting the progress of the construction if held strictly liable for unreasonably dangerous defects. This really would cast no greater burden upon them, for lending institutions already owe a duty of care to stockholders to make sure housing on which they loan money will be sound enough to serve as proper collateral. As standard practice, savings and loan associations normally check soil conditions for potential foundation hazards, usually at the borrower's expense; inspect plans to insure that they are adapted to the building site; and check for structural defects during the course of construction when lending money for residential construction projects.[28]

Under the strict liability theory, lenders of course would not have to fear that they would be held accountable for any and all defects. The theory is founded upon the idea that the house will be reasonably fit for the purpose for which it is sold. Only if it is defective through a condition unreasonably dangerous to persons using it or to their property would strict liability be imposed.[29]

As illustrated by the fact situation in *Connor*, courts should consider a number of factors in determining whether to impose strict liability on a lender backing a builder-vendor. While the decisions necessarily must develop on a case by case basis, the experience of the builder-vendor, its solvency, the control exercised by the lending institution, and the degree to which the lender becomes enmeshed in the enterprise are all highly relevant elements for consideration concerning the ultimate issue of lender liability. For instance, a lender that so involves itself in the housing scheme that it in effect becomes an entrepreneur ought to bear the full risks of its involvement to the extent of strict liability. Lenders financing

[27] For a discussion speculating as to the effect of these risk-spreading devices on the housing industry, see *id.* at 754-55.

[28] UNITED STATES SAVINGS & LOAN LEAGUE, CONSTRUCTION LOAN PROCEDURES 5, 8, 36 (1966).

[29] Schipper v. Levitt & Sons, 44 N.J. 70, 92, 207 A.2d 314, 326 (1965).

inexperienced or financially-weak builders should under the *Connor* doctrine exercise control over the projects to insure sound construction; but even if they choose not to do so, such lenders should be held strictly liable for housing defects since their money launched the homes on the market. On the other hand, lending institutions that provide money for experienced, solvent builders and that are not negligent toward potential purchasers for not exercising substantial control over the planning and construction of the homes, and that do not involve themselves in the enterprise to an extent greater than lending money outright to the builder-vendor should not face strict tort liability for defective homes. Indeed, under the holding in *Connor*, they would not be liable in negligence. The circumstances surrounding each case would determine, of course, the weight a court would give each relevant element.

One difficulty in holding lenders strictly liable may be the issue of whether the independent contractor who builds and sells one house at a time should be held strictly liable for dangerous defects. It has been suggested that courts may distinguish between the subdeveloper who builds a number of homes and the independent contractor.[30] However, both Texas and Mississippi have declined to recognize any such distinction[31] and the New Jersey Supreme Court did not take the opportunity to do so in a recent case.[32] Logically lenders should not be held strictly liable where there is no basis for such liability in the builders that they support. But the decisions indicate that where courts are willing to apply strict liability to builder-vendors, the size of their operation makes no difference. Just as the large developer, the independent contractor

> is in full control of the construction of the house and therefore is in the best position to assume the responsibility for remedying structural defects. If he reaps profits from his activities, he ought to bear the risks involved in these activities. Consequently, he will use greater care to protect the lives and property of users of the home.[33]

[30] The basic argument in favor of such a distinction is that the small, independent contractor is a poor risk-bearer and risk-shifter. *See, e.g.*, Note, *Builder-Vendors: Liability for Negligence and for Breach of Implied Warranty of Habitability*, 51 CORNELL L. REV. 389, 399-400 (1965); Note, 41 WASH. L. REV. 166, 172-73 (1966); *Recent Developments, the Strict Tort Liability of Builder-Vendors*, 28 OHIO ST. L.J. 343, 352 (1967).

[31] State Stove Mfg. Co. v. Hodges, — Miss. —, 189 So. 2d 113, *cert. denied*, 386 U.S. 912 (1966); Humber v. Morton, 426 S.W.2d 554 (Tex. 1968).

[32] Totten v. Gruzen, 52 N.J. 202, 245 A.2d 1 (1968).

[33] *Recent Developments, the Strict Tort Liability of Builder-Vendors, supra* note 30, at 351 (citations omitted).

In short, the argument that the single contractor is often a poor risk-bearer and risk-shifter can be obviated if the lender who backs him is also held strictly liable.

Under any extension of strict liability to the lender, the builder-vendor should remain primarily liable since he is the one with the most immediate control over the construction. Then the lending agency can protect itself not only by spreading the risk through interest rates on loans and requiring the borrower to insure against products liability, but can also seek indemnification from a solvent builder who builds a defective house, at least if the builder was actively negligent.[34] These methods of protection might make courts less reluctant in the future to extend the *Connor* principle so that lenders financing builder-vendors are strictly liable for housing defects.

When all arguments on the subject are examined, such vicarious strict liability for lenders must rest on a social policy concept rather than on a fault principle. But this is nothing new in the law of torts.

> Vicarious liability is based on a relationship between the parties, irrespective of participation, either by act or omisson, of the one vicariously liable, under which it has been determined as a matter of policy that one person should be liable for the act of the other. Its true basis is largely one of public or social policy under which it has been determined that, irrespective of fault, a party should be held to respond for the acts of another.[35]

THOMAS F. LOFLIN III

Torts—Municipal Corporations—Liability for Failure to Provide Requested Police Protection Against Assault by a Third Person

The doctrine of immunity for municipal corporations has long been invoked to insulate municipalities from liability for the torts of their law enforcement officials.[1] Even in those jurisdictions that have abolished

[34] *See* Comment, *Liability of the Institutional Lender for Structural Defects in New Housing*, *supra* note 3, at 760-61 & n.122.

[35] Nadeau v. Melin, 260 Minn. 369, 375-76, 110 N.W.2d 29, 34 (1961) (citations omitted).

[1] On the doctrine of municipal immunity, see generally W. PROSSER, LAW OF TORTS 996-1013 (3rd ed. 1964) [hereinafter cited as PROSSER]. As to municipal liability for the torts of law enforcement officials, see 18 E. MCQUILLEN, MUNICIPAL CORPORATIONS §§ 53.79-53.81a (3rd ed. 1963); Comment, *Municipal Liability for Police Torts: An Analysis of a Strand of American Legal History*, 17 U. MIAMI L. REV. 475 (1963).

municipal immunity, however, a city does not become an insurer for those who are injured by the acts or omissions of police officers. Rather, the municipality is answerable in accordance with the same rules of law applicable to individuals and private corporations.[2] Municipal liability is thus imposed or limited by traditional concepts of tort law.

The recent case of *Riss v. City of New York*[3] is illustrative. Plaintiff was an attractive young woman who for more than six months had been terrorized by threats from a rejected suitor. Her repeated pleas for police protection were received with little more than indifference. Upon learning that plaintiff had become engaged to another, the suitor once more threatened to have her killed or maimed, indicating that it was her "last chance." Again the police refused to respond to her pleas for help. The next day a hired thug threw lye in plaintiff's face. She was blinded in one eye, lost a good portion of her vision in the other, and her face was permanently disfigured. She was given around-the-clock police protection for three and one-half years following the assault.

The Court of Appeals of New York affirmed a dismissal of the complaint, holding, despite a strong dissent, that police have no duty to furnish requested protection against assaults by third parties to individual members of the community. The failure to recognize such a duty was obviously predicated upon a general fear of the burdensome consequences that might ensue, and upon the uncertainty of whether liability based upon such a duty could be held within reasonable bounds. In so holding, the court failed to explore fully the relevant policy considerations. Moreover, in hinging its decision on the duty issue, it apparently did not consider the availability of other tort concepts that could be utilized to circumscribe the area of responsibility.

To merely state that there is or is not a duty would be, of course, to beg the essential question of whether plaintiff's interests are entitled to legal protection against the defendant's conduct.[4] Although various attempts have been made to define the factors that are relevant to the determination of a legally recognizable duty, the question can be answered

[2] *E.g.*, Brinkman v. City of Indianapolis, — Ind. —, 231 N.E.2d 169 (1967).

[3] 22 N.Y.2d 579, 240 N.E.2d 860, 293 N.Y.S.2d 897 (1968). The New York law abolishing municipal immunity consists of specific statutory enactments augmented by a broader decisional liability. *See* Bernardine v. City of New York, 294 N.Y. 361, 62 N.E.2d 604 (1945); Comment, *Municipal Liability for Torts of Firemen*, 31 ALBANY L. REV. 256 (1967).

[4] PROSSER 332-33.

only by an assessment of all policy considerations relevant to the factual situation at hand.[5]

Difficulties of administration have always been of great significance in any new development of the law,[6] and fear of admittedly unpredictable administrative consequences may have been a factor in the *Riss* decision. It is significant to observe, however, that such fear of drastically increased caseloads and groundless suits has seldom materialized.[7] Yet, for this reason, courts originally denied recovery for injuries resulting in death,[8] refused to allow recovery for nervous shock unless accompanied by a physical impact,[9] and denied protection to injured consumers of manufactured products in the absence of privity of contract with the manufacturer.[10] Undeniably the cumulative effect of recognizing these interests has had a significant impact upon the administrative burden of the courts, but in no single instance has the resultant burden been in proportion to the fears that it engendered. Furthermore, the existence of modern procedural devices makes it increasingly improbable that unmeritorious actions can survive.[11]

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[5] The ultimate question is whether such a duty *should* be imposed as a matter of policy. This in turn will depend upon the balancing of several factors, namely the burden it would put on defendant's activity; the extent to which the risk is one normally incident to the activity; the risk and the burden to plaintiff; the respective availability and cost of insurance to the two parties; the prevalence of insurance in fact . . . .

2 F. HARPER & F. JAMES, LAW OF TORTS § 18.6, at 1052 (1956) [hereinafter cited as HARPER & JAMES].

[6] See Green, *The Duty Problem in Negligence Cases*, 28 COLUM. L. REV. 1014, 1044-45 (1928). See also Comment, *Municipal Immunity for the Torts of Police Officers in South Dakota*, 11 S.D.L. REV. 87 (1966), where it is stated:

> The initiation of municipal liability would ultimately result in an increase in the number of suits brought in local courts and might possibly stimulate false claims. Such an increase could overload our present judicial system and swamp the courts in a sea of litigation . . . .

Id. at 98.

[7] See Antieau, *Statutory Expansion of Municipal Tort Liability*, 4 ST. LOUIS U.L.J. 351 (1957). Dean Leon Green has suggested that courts have overestimated the number of cases that may be attributed to the negligence of governmental employees. Green, *Freedom of Litigation*, 38 ILL. L. REV. 369 (1944).

[8] *E.g.*, Connecticut Mut. Life Ins. Co. v. New York & N.H.R.R., 25 Conn. 265 (1856); Baker v. Bolton, 170 Eng. Rep. 1033 (K.B. 1808).

[9] Brisboise v. Kansas City Pub. Serv. Co., 303 S.W.2d 619 (Mo. 1957); Bosley v. Andrews, 393 Pa. 161, 142 A.2d 263 (1958).

[10] *E.g.*, Berger v. Standard Oil Co., 126 Ky. 155, 103 S.W. 245 (1907); Windram Mfg. Co. v. Boston Blacking Co., 239 Mass. 123, 131 N.E. 454 (1921); Heizer v. Kingsland & Douglas Mfg. Co., 110 Mo. 605, 19 S.W. 630 (1892).

[11] Modern pre-trial and discovery procedures should aid in the weeding out of groundless suits. Furthermore, prompt notice is normally a condition precedent to a suit against a municipality and should serve to thwart the malingering plaintiff.

In addition to the administrative considerations involved in carving out new areas of tort liability, the relative economic burdens to which the litigants may be subjected have concerned the courts.[12] The fear of potentially unbearable financial burdens that might be thrust upon municipalities has been a major factor in perpetuating the doctrine of municipal immunity.[13] Furthermore, even where the immunity doctrine has been abolished, courts have continued to fret over the specter of a depleted municipal treasury.[14] Yet empirical studies indicate that the imposition of tort liability has not saddled municipalities with as great a financial burden as was feared.[15] Of course, if recognition of a duty to provide police protection against personal assaults would seriously jeopardize the public treasury, such a duty should be denied.

It appears that courts, in assessing the potential economic impact, may have failed to distinguish between those losses attributable to the lack of adequate police protection and those involving a failure to provide fire protection. Such a comparison is imprecise at best. Municipal liability for fire damage could well become a crushing financial burden in the event of a conflagration. Moreover, fire insurance is widely held by property owners and, in comparison with the cumbersome process of imposing legal liability upon a city, may represent a more economical way to administer fire losses.[16] On the other hand, while personal accident insurance normally covers injuries intentionally inflicted by others,[17] it is unlikely that the coverage would be sufficient to compensate for serious injury or death. Furthermore, it may be that those who need such insurance the most are least likely to hold it.[18]

The possibility that a duty to provide police protection against per-

[12] "Finally . . . judges give attention to the parties before them. They place the loss where it will be felt the least and can best be borne." Green, *The Duty Problem in Negligence Cases: II*, 29 COLUM. L. REV. 255, 256 (1929).

[13] See Warp, *Tort Liability Problems of Small Municipalities*, 9 LAW & CONTEMP. PROB. 363 (1942).

[14] *E.g.*, Steitz v. City of Beacon, 295 N.Y. 51, 64 N.E.2d 704 (1945).

[15] See Antieau, *supra* note 7; Warp, *supra* note 13.

[16] HARPER & JAMES § 18.6, at 1053; *cf.* Van Alstyne, *Governmental Tort Liability: A Public Policy Prospectus*, 10 U.C.L.A.L. REV. 463, 513 (1963).

[17] 45 C.J.S. *Insurance* § 772 (1955).

[18] National victimization rates indicate that the risk of criminally inflicted personal injury is considerably greater for those persons in lower income groups. THE PRESIDENT'S COMMISSION ON LAW ENFORCEMENT AND ADMINISTRATION OF JUSTICE, THE CHALLENGE OF CRIME IN A FREE SOCIETY 19 (1967). Because of their economic status (and perhaps other cultural factors), these individuals are less likely to carry personal accident insurance.

sonal injury, once recognized, might easily be extended to include a duty to protect against property loss, may be another factor in perpetuating fears of drastic financial burdens. However, the availability and practicality of property insurance, as distinguished from accident insurance, may also provide a rational basis for limiting liability for failure to provide police protection to those instances that involve personal injury. In addition, the municipality could insure against liability and spread the cost of premiums among the taxpaying public.

In refusing to recognize a duty to provide police protection because of the potential administrative and economic consequences, courts have apparently ignored the existence of other tort principles—principles that, given the existence of the duty, could still be used to hold liability within reasonable bounds.[19] Negation of the doctrine of municipal immunity does not contemplate the imposition of absolute liability; those seeking recovery must still satisfy the traditional elements of a negligence action. In addition to the establishment of a duty, plaintiff must also show a failure to exercise reasonable care in the performance of that duty. The application of a standard of reasonable care to the operation of a municipal police department would require that all circumstances be taken into consideration. The gravity of the foreseeable harm, the resources and other responsibilities of the police, the probability of injury, and the extent of protection necessary to prevent the injury would all be relevant factors.[20] Furthermore, given the duty and the breach of that duty, plaintiff must also establish a causal relationship between the breach and the injury, often in itself a formidable task. The availability of these traditional tort concepts, therefore, may be adequate to circumscribe the area of responsibility.

Quite apart from administrative and economic considerations, courts may rely upon the traditional dichotomy between misfeasance and nonfeasance to deny the existence of a duty to provide police protection against personal assault.[21] The distinction between active misconduct working positive injury, and passive inaction or failure to protect from harm, is

[19] Comment, *Municipality Liable for Negligent Failure to Protect Informer: The Schuster Case*, 59 COLUM. L. REV. 487, 503 (1959) [hereinafter cited as 59 COLUM. L. REV.].

[20] *Id.* at 503.

[21] *E.g.*, Murrain v. Wilson Lines, Inc., 270 App. Div. 372, 59 N.Y.S.2d 750 (1946), *aff'd*, 296 N.Y. 845, 72 N.E.2d 29 (1947) (although municipal immunity had been waived by statute, municipality not liable for failure to provide police protection).

deeply rooted in the common law.[22] Various rationalizations have been offered to explain the distinction, most of which appear to be a product of the extreme individualism characteristic of Anglo-Saxon legal thought.[23] It has been said that active conduct creates a new risk, while mere inaction fails to alter the status quo;[24] that one should provide for his own protection; and that forcing affirmative conduct places a more serious restraint upon personal freedom than imposing limitations on one's liberty to act.[25] A further, and perhaps more rational, justification for refusing to recognize a duty of affirmative action is the difficulty of imposing liability upon a particular individual when all members of a group have had the opportunity and failed to act.[26]

The misfeasance-nonfeasance rule is not without exception. A duty imposed by statute or charter has in some instances given rise to liability for a failure to act. For example, persons injured in automobile accidents have recovered upon the theory that the state failed to perform its statutory duty to maintain safe highways.[27] Liability has been denied, however, in cases where the cause of action is based upon a statutory or charter-imposed duty to provide police services.[28] The courts usually attempt to explain the distinction upon the rather dubious theory that the duty to maintain highways inures to the benefit of the individual members of a particular class of persons, while the duty to provide police protection runs to the general public rather than particular individuals.[29]

Additional theories have been utilized to undercut the nonfeasance rule. Courts have held that a duty to act may be created by the existence of a special relationship between the parties;[30] that one who gratuitously undertakes to render aid to another is under a duty to continue, unless withdrawal of such assistance would leave the other in a position no worse than when the aid was initially extended;[31] and that a duty to act

[22] PROSSER 334-46; Bohlen, *The Moral Duty to Aid Others as a Basis of Tort Liability*, 56 U. PA. L. REV. 217 (1908); Comment, *Affirmative Duties in Tort*, 58 YALE L.J. 1272 (1949).

[23] Bohlen, *supra* note 22, at 220.

[24] PROSSER 334; Bohlen, *supra* note 22, at 220-21.

[25] Comment, *Affirmative Duties in Tort*, *supra* note 22, at 1288.

[26] PROSSER 336-37.

[27] *E.g.*, Eastman v. State, 278 App. Div. 1, 102 N.Y.S.2d 925, *aff'd*, 303 N.Y. 691, 103 N.E.2d 56 (1951).

[28] 59 COLUM. L. REV. at 492.

[29] *Id.*

[30] *See generally* HARPER & JAMES § 18.7; HARPER & KIME, *The Duty to Control the Conduct of Another*, 43 YALE L.J. 886 (1934).

[31] 2 RESTATEMENT (SECOND) OF TORTS §§ 323-24 (1965).

may be found when one's prior conduct has created a risk of harm to another.[32] In *Schuster v. City of New York*,[33] these exceptions were applied in order to impose liability for failure to provide police protection. After recognizing Willie "the Actor" Sutton, an escaped criminal, Schuster promptly notified the police. After Sutton's arrest the police publicly acknowledged Schuster's role in effectuating the capture. Following telephone calls that threatened physical violence, Schuster was shot to death on a public street by unidentified persons. A decision affirming the trial court's dismissal of the complaint for failure to state a cause of action was reversed, on the theory that plaintiff's performance of his public "duty" to aid in the apprehension of a criminal gave rise to a reciprocal governmental duty to exercise reasonable care for his protection, or alternatively, that the city had a duty to continue the partial protection that had been extended. It has also been suggested that the publicity acknowledging Schuster's role in the capture could have been classified as prior conduct that created a risk of harm, thus giving rise to a duty to provide protection.[34]

One eminent commentator has suggested that *Schuster* could have been decided on the theory of a duty to exercise control over the conduct of third persons.[35] Courts have applied such a rule to impose an obligation upon common carriers to protect their passengers from the wrongful conduct of third persons,[36] and, in addition, the rule has been applied to such relationships as innkeeper-guest,[37] employer-employee,[38] jailer-prisoner,[39] and school-pupil.[40] Admittedly, the opportunity to control the potential wrongdoer in these relationships is inherently greater than that

[32] *Id.* § 321.

[33] 5 N.Y.2d 75, 154 N.E.2d 534, 180 N.Y.S.2d 265 (1958). The *Riss* court cited and distinguished the *Schuster* case: "Quite distinguishable, of course, is the situation where the police authorities undertake responsibilities to particular members of the public and expose them, without adequate protection, to the risks which then materialize into actual losses . . . ." Riss v. City of New York, 22 N.Y.2d 579, —, 240 N.E.2d 860, 861, 293 N.Y.S.2d 897, 899 (1968).

[34] 59 COLUM. L. REV. at 495.

[35] PROSSER 344-45.

[36] *E.g.*, Birmingham Elec. Ry. Co. v. Driver, 232 Ala. 36, 166 So. 701 (1936); Kline v. Milwaukee Elec. Ry. & Light Co., 146 Wis. 134, 131 N.W. 427 (1911).

[37] *E.g.*, Fortney v. Hotel Bancroft, Inc., 5 Ill. App. 2d 327, 125 N.E.2d 544 (1955).

[38] *E.g.*, David v. Missouri Pac. R.R., 328 Mo. 437, 41 S.W.2d 179 (1931).

[39] *E.g.*, Taylor v. Slaughter, 171 Okla. 152, 42 P.2d 235 (1935).

[40] *E.g.*, McLeod v. Grant County Sch. Dist., 42 Wash. 2d 316, 255 P.2d 360 (1953).

which exists in the context of a police protection case.[41] But this distinction overlooks the fact that controlling the conduct of wrongdoers is the very essence of police work. Furthermore, if the opportunity to exert control over a potential wrongdoer is a factor to consider, then *Riss*, a case in which the identity of the plaintiff's suitor was known, becomes a stronger case for recognition of the duty than *Schuster*, where the party who made the threatening calls was unidentified.

Although the duty to protect was recognized in *Schuster*, it is clear that a plaintiff such as in *Riss* could not avail himself of either the "assumption of duty" or the "prior dangerous conduct" exceptions to the nonfeasance rule. Moreover, the New York court was obviously unwilling to find a special relationship—one that had been afforded to Schuster because of his status as an informer. The nonfeasance rule should not, however, be sacrosanct. It would seem that many of the justifications traditionally advanced for the distinction do not apply to a failure to provide police protection against assault by a third person.[42] The common law attitude of individualism, which regarded men as independent and self-reliant, should perhaps be tempered by the realization that, notwithstanding one's ruggedness, there may be occasions when preservation of life is dependent upon the affirmative action of the police.[43] Moreover, the rationale that regards the imposition of an affirmative duty to act as a serious encroachment upon individual liberty surely has no application to members of an institution charged with maintenance of the public safety. Even the most rational justification—the difficulty of imposing liability upon one of several who failed to render aid—is clearly inapplicable.

Considering the inapplicability of the traditional nonfeasance rules, it therefore seems quite plausible to argue that the potentially catastrophic individual loss brought about by a clear failure to protect life should weigh more heavily than the more remote possibility of serious administrative consequences or economic loss to the municipality.

JAMES G. BILLINGS

[41] *See* Note, *Torts: Municipal Corporation's Liability for Failure to Perform Governmental Acts*, 47 CAL. L. REV. 409, 412 (1959).

[42] 59 COLUM. L. REV. at 502.

[43] *Cf.* Hale, *Prima Facie Torts, Combination, and Non-Feasance*, 46 COLUM. L. REV. 196, 214 (1946).

Torts—Recognition of Wife's Right to Husband's Consortium

Consortium is the conjugal fellowship of husband and wife, and the right of each to the company, cooperation, affection, and aid of the other.[1] The three most prominent elements in the unique consortium interest are services, sexual intercourse, and general companionship.[2] Notwithstanding the intangible value of the "sentimental" elements inherent in the consortium interest, the common law early recognized the husband's legal right to consortium.[3]

Adhering to the common law, most states initially recognized a separate and independent cause of action in the husband for loss of consortium as a result of a defendant's negligent injury to his wife.[4] A mutual cause of action was not afforded the wife because at common law she had no reciprocal proprietary rights in her husband.[5] The relationship of the wife to the husband was that of servant to master, and the servant had no interest in the master.[6] The wife could only recover for injuries to herself by bringing a suit in her husband's name, and since she had no property rights, any recovery inured to the benefit of her husband.[7]

With the advent of the Married Women's Acts, the wife was granted the right to sue, the right to be sued, the right to contract, and the right to own and control property.[8] At the turn of the twentieth century, courts began to recognize the wife's consortium interest by allowing her to

[1] BLACK'S LAW DICTIONARY 382 (4th ed. 1951). "In old English law, the term signified company or society, and in the language of pleading, as in the phrase *per quod consortium amisit*, it has substantially the same meaning, viz., the companionship or society of a wife . . . ." *Id.*

[2] "The concept of consortium includes not only loss of support, it also embraces such elements as love, companionship, affection, society, sexual relations, solace and more." Millington v. Southeastern Elev. Co., 22 N.Y.2d 498, —, 239 N.E.2d 897, 899, 293 N.Y.S.2d 305, 308 (1968).

[3] Hyde v. Scyssor, 79 Eng. Rep. 462 (K.B. 1620). *See generally* Note, *Case of the Lonely Nurse: The Wife's Action for Loss of Consortium*, 18 WES. RES. L. REV. 621 (1967).

[4] W. PROSSER, THE LAW OF TORTS § 119 (3d ed. 1964) [hereinafter cited as PROSSER].

[5] *Id.* at 916.

[6] Blackstone compared the relationship of the husband and wife to that of master and servant: "[T]he inferior hath no kind of property in the company, care, or assistance of the superior, as the superior is held to have in those of the inferior; and therefore the inferior can suffer no loss or injury." 3 W. BLACKSTONE, COMMENTARIES 143 (Lewis ed. 1897).

[7] PROSSER § 111, at 881.

[8] *Id. See, e.g.*, N.C. GEN. STAT. § 52-10 (1953).

recover for an *intentional interference* with her marital relationship.[9] This recognition set the stage for the decision of the Supreme Court of North Carolina in *Hipp v. E.I. Dupont de Nemours & Co.*,[10] where the court allowed a wife to recover for loss of consortium as a result of a negligent injury to her husband. The court reasoned that the Married Women's Act was intended to give the wife separate legal remedies for the same rights and remedies allowed a husband. Thus, the court saw no reason to withhold from the wife the consortium action that the husband enjoyed. Five years later, however, in *Himant v. Tide Water Power Co.*[11] the court not only abolished such an action in the wife,[12] but also implied that the Married Women's Act extinguished this consortium right in the husband. Then, in *Helmstetler v. Duke Power Co.*[13] the husband's cause of action was expressly abolished.[14]

This issue remained dormant in most jurisdictions until the landmark decision of the District of Columbia Circuit in *Hitaffer v. Argonne Co.*,[15] which allowed the wife a reciprocal action for loss of consortium as a result of a negligent injury to her husband. Following the trend established by *Hitaffer*,[16] fifteen states now recognize a cause of action in

[9] PROSSER § 118, at 903. An intentional interference with the marital relations is the basis of actions such as criminal conversation, alienation of affections, or enticement. The damages recoverable in these actions are for loss of consortium, and courts have interpreted the Married Women's Acts or more specific statutes as recognizing a wife's mutual consortium interest in her husband.

[10] 182 N.C. 9, 108 S.E. 318 (1921). *See* Note, 3 N.C.L. REV. 98 (1925).

[11] 189 N.C. 120, 126 SE. 307 (1925). *See Note*, 3 N.C.L. REV. 98 (1925).

[12] The court apparently reasoned that the wife had no right to recover for the loss of her husband's domestic services since he recovered his loss to perform those services in his own action for personal injury. Since loss of services was the prominent, if not indispensable, element of a consortium action, the wife had no basis for her action. Without a loss of services, the other elements involved in loss of consortium were not a proximate result of the injury to the husband.

[13] 224 N.C. 821, 32 S.E.2d 611 (1945).

[14] The reasoning of the court was that, as a result of the Married Women's Act, the wife had to recover any loss of ability to perform domestic services in her own personal injury action; thus, since the husband did not have a right to recover for loss of his wife's services, a necessary element of his consortium action, he had no basis for the consortium action.

[15] 183 F.2d 811 (D.C. Cir. 1950), *cert. denied*, 340 U.S. 852 (1950). *See* Note, *Loss of Consortium from Injury to Spouse*, 29 N.C.L. REV. 178 (1951).

[16] *See, e.g.*, Jaffe, *Damages for Personal Injury: The Impact of Insurance*, 18 LAW & CONTEMP. PROB. 219 (1953); Payne, *Tortious Invasions of Right of Marital Consortium*, 8 J. FAM. LAW 41 (1968); Rossman & Allen, *What's New in the Law: Husband and Wife—Consortium*, 52 A.B.A.J. 492 (1966); Spero, *Wife's Action for Loss of Consortium*, 17 CLEV.-MAR. L. REV. 462 (1968); Note, 26 MD. L. REV. 361 (1966); Note, *Loss of Consortium from Injury to Spouse*, 29 N.C.L. REV. 178 (1951); Note, *Case of the Lonely Nurse: The Wife's Action for Loss of Consortium*, 18 WES. RES. L. REV. 621 (1967).

either spouse when the other is negligently injured.[17] Seventeen states, however, continue to confine such right to the husband,[18] and at least seven other states afford the action to neither spouse.[19]

In *Millington v. Southeastern Elevator Co.*,[20] New York became the fifteenth state to recognize this consortium action in either spouse as a result of a negligent injury to the other spouse. The plaintiff-wife asked the court to recognize that she had been deprived of definite rights involved in her marital relationship when her husband had been paralyzed from his waist down because of the defendant's negligence. The defendant raised at least five major arguments that, taken together, have been advanced in other courts to deny the wife's right to recover. But the reasoning of these arguments in fact "take[s] us on a tour similar to that of Minos in the labyrinth of Daedalus. Each path leads to a dead end of reasoning and logic."[21]

The first major argument offered for denying a consortium action to the wife is that the Married Women's Acts were not intended to give the wife any new rights, but were only to provide her with personal remedies for rights that she always had at common law, which did not include the right to her husband's consort. Thus, allowing the wife to bring an action for loss of consortium would not only be granting her a new right and remedy, contrary to the purpose of the Married Women's Acts, but also would be invading the legislative domain.[22] The critics of such logic assert that the wife did have a right to her husband's consort

[17] Arkansas, Delaware, Georgia, Idaho, Illinois, Iowa, Maryland, Michigan, Missouri, New Jersey, New York, Ohio, Oregon, South Dakota, and Wisconsin. The following federal decisions interpreting state law have allowed the action to either spouse in additional states: Luther v. Maple, 250 F.2d 916 (8th Cir. 1958) (interpreting Nebraska law); Owen v. Illinois Baking Corp., 260 F. Supp. 820 (W.D. Mich. 1966) (interpreting Indiana law); Dutton v. Hightower & Lubrecht Constr. Co., 214 F. Supp. 298 (D. Mont. 1963) (interpreting Montana law). *But see* Miskunas v. Union Carbide Corp., 399 F.2d 847 (7th Cir. 1968) (interpreting Indiana law *not* to allow the action to the wife).

[18] Alabama, Florida, Indiana, Kansas, Kentucky, Maine, Minnesota, Mississippi, New Hampshire, New Mexico, North Dakota, Oklahoma, Pennsylvania, South Carolina, Tennessee, Vermont, and West Virginia.

[19] California, Connecticut, Louisiana, Massachusetts, North Carolina, Rhode Island, and Virginia. *See* Black v. United States, 263 F. Supp. 470 (D. Utah 1967) (interpreting Utah's law to allow neither spouse the action).

[20] 22 N.Y.2d 498, 239 N.E.2d 897, 293 N.Y.S.2d 305 (1968), *overruling* Kronenbitter v. Washburn Wire Co., 4 N.Y.2d 524, 151 N.E.2d 898, 176 N.Y.S.2d 354 (1959).

[21] Montgomery v. Stephan, 359 Mich. 33, 41, 101 N.W.2d 227, 231 (1959).

[22] *See, e.g.*, Hinnant v. Tide Water Power Co., 189 N.C. 120, 126 S.E. 307 (1925); Page v. Winter, 240 S.C. 516, 126 S.E.2d 570 (1962).

at common law, but no remedy, and that the very purpose of the Married Women's Acts was to grant remedies to the wife for rights such as consortium.[23]

Both of these arguments concerning whether the wife has a right without a remedy at common law seem meaningless in light of the Married Women's Acts. The general legislative intent behind the Acts was apparently that of affording the wife a legal status equal to her husband's.[24] Moreover, since the Acts are generally interpreted as giving the wife a new cause of action for an intentional interference with her marital relations, an action which she did not have at common law,[25] it is inconsistent to argue that the same Acts did not similarly give her a new consortium action for a negligent injury to her husband.[26]

A second argument advanced against permitting the wife a recovery under the consortium action is that the creation of a new cause of action and the subsequent extension of the defendant's liability should be left to the legislatures.[27] This argument is closely related to the first argument because it assumes that the legislature has not already spoken through the Married Women's Acts.[28] Yet, fear of invading the legislative domain is anomalous when a court asserts that the creation of a consortium action in the wife should be left for the legislature, but then abolishes the husband's action in order to achieve symmetry and equality.[29] "Thus a case

[23] *See, e.g.*, Page v. Winter, 240 S.C. 516, 519, 126 S.E.2d 570, 572 (1962) (dissenting opinion).

[24] *See, e.g.*, Knighten v. McClain, 227 N.C. 182, 44 S.E.2d 79 (1947); Karchner v. Mumrie, 398 Pa. 13, 156 A.2d 537 (1959). *See* PROSSER § 118, at 903.

[25] *Id.*

[26] *Compare* Hinnant v. Tide Water Power Co., 189 N.C. 120, 126 S.E. 307 (1925), *with* Knighten v. McClain, 227 N.C. 682, 44 S.E.2d 79 (1947); *compare* Neuburg v. Bobowicz, 401 Pa. 146, 162 A.2d 662 (1960), *with* Karchner v. Mumrie, 398 Pa. 13, 156 A.2d 537 (1959).

[27] *See, e.g.*, Smith v. United Constr. Workers, 271 Ala. 42, 122 So. 2d 153 (1960); West v. San Diego, 54 Cal. 2d 469, 353 P.2d 929, 6 Cal. Rptr. 289 (1960); Page v. Winter, 240 S.C. 516, 126 S.E.2d 570 (1962).

[28] Once a court realizes that the traditional arguments against the wife's consortium action stem from antiquated common law fictions, it becomes "as much the duty of this court to restore a right which has been erroneously withheld by judicial opinion as it is to recognize it properly in the first instance." Brown v. Georgia-Tenn. Coaches, Inc., 88 Ga. App. 519, 533, 77 S.E.2d 24, 32 (1953).

[29] *See, e.g.*, West v. San Diego, 54 Cal. 2d 469, 353 P.2d 929, 6 Cal. Rptr. 289 (1960). *Compare* Hinant v. Tide Water Power Co., 189 N.C. 120, 126 S.E. 307 (1925), *with* Helmstetler v. Duke Power Co., 224 N.C. 821, 32 S.E.2d 611 (1945). These courts seem to be "legislating" unreasonably when they abolish the husband's action that has been established since early common law. Moreover, equality and symmetry in our laws are usually thought of as being attained by giving the deprived group the same rights as the more privileged group, not by eliminating the latter's rights.

predicated upon the theory that the court is bound to follow the common law rule becomes converted into a case holding that the court must now reverse a common law rule."[30] Admittedly, if a state's wrongful death statute restricts recovery of a surviving spouse to pecuniary loss,[31] the court could infer a legislative intent against the sentimental elements involved in the consortium action. On the other hand, the opposite inference is logical in those states that do allow recovery for loss of companionship and other sentimental elements under their wrongful death statutes.[32]

Similar arguments against courts creating new causes of action and thus legislating have been espoused to thwart recovery for prenatal injury,[33] mental distress,[34] and the right to privacy,[35] but the courts have had little trouble "enacting" these new torts. In fact, the law of torts is highly "judge-made," and perhaps its strength lies in this fact.[36]

The third major argument is based on the premise that the so-called "sentimental" elements of a husband's action for loss of consortium are parasitic to the basic and indispensable element of services, and since the wife has never had a reciprocal right to her husband's services, she cannot have a right to his consortium.[37] Those who oppose such reasoning claim that the loss of services element was never an indispensable element of the husband's action for loss of consortium, and that the wife's action should merely be limited to the other elements within the consortium interest.[38]

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[30] West v. San Diego, 54 Cal. 2d 469, 485, 353 P.2d 929, 939, 6 Cal. Rptr. 289, 299 (1960) (dissenting opinion).

[31] *E.g.*, Greene v. Nichols, 274 N.C. 18, 161 S.E.2d 521 (1968) (the pecuniary loss rule). The North Carolina pecuniary loss limitation has now been amended to allow recovery of consortium elements in a wrongful death action. *See* N.C. GEN. STAT. § 28-174 (*as amended* by S.B. 95, 1969 General Assembly).

[32] West v. San Diego, 54 Cal.2d 469, 487, 353 P.2d 929, 940, 6 Cal. Rptr. 289, 300 (1960) (dissenting opinion).

[33] PROSSER § 56, at 355. The initial "legislative" decision for this tort, which almost every state court has now recognized, came from the District of Columbia, as did the landmark decision allowing the wife a consortium action. Bonbrest v. Kotz, 65 F. Supp. 138 (D.D.C. 1946). *See* note 15 *supra*, and accompanying text.

[34] PROSSER § 55.

[35] *Id.* § 112.

[36] In Montgomery v. Stephan, 359 Mich. 33, 101 N.W.2d 227 (1960), the court answered the legislative argument very appropriately: "The obstacles to the wife's action were judge-invented and they are herewith judge-destroyed." *Id.* at 49, 101 N.W.2d at 235.

[37] *See, e.g.*, Hitaffer v. Argonne, 183 F.2d 811 (D.C. Cir. 1950); Ripley v. Ewell, 61 So. 2d 420 (Fla. 1952); Hoffman v. Dautel, 192 Kan. 406, 388 P.2d 615 (1964); Hinnant v. Tide Water Power Co., 189 N.C. 120, 126 S.E. 307 (1925).

[38] *See, e.g.*, Montgomery v. Stephan, 359 Mich. 33, 101 N.W.2d 227 (1960).

Loss of services was a probable element of the husband's consortium action for a negligent injury to his wife at common law, but the courts did not feel compelled to assert it as indispensable until the wife attempted to bring a similar action when her husband was injured by a negligent defendant.[39] Moreover, the loss of services is not indispensable to a wife's action for an intentional interference with her marital relations.[40]

Judicial treatment of the "sentimental" elements of the consortium interest as parasitic to the service element is similar to the requirement at common law of an immediate impact to the person of the plaintiff in order for him to maintain an action for negligent infliction of mental distress.[41] Although few courts require this today, most courts do continue to require consequential physical effects to which the "parasitic" damages of mental distress may attach.[42] The apparent purpose behind this basic prerequisite to both a negligent infliction of mental distress action and the loss of consortium action is that of establishing tangible damages and preventing fictitious claims.[43] A more realistic approach, however, would be to recognize that the essence of recovery is for the damage to these intangible but important interests, and that the requirement of a superficial scratch[44] or

[39] In earlier cases from states purporting to follow the common law rule, where a husband brought an action for loss of consortium as a result of an injury to his wife, services are not mentioned as indispensable to his action. *See, e.g.*, Kimberly v. Howard, 143 N.C. 398, 55 S.E. 778 (1906) (husband can recover for loss of society *or* services of his wife); Holleman v. Howard, 119 N.C. 150, 25 S.E. 972 (1896) (same).

[40] *See, e.g.*, Litchfield v. Cox, 266 N.C. 622, 146 S.E.2d 641 (1966); Knighten v. McClain, 227 N.C. 682, 44 S.E.2d 79 (1947). See also PROSSER § 118, at 904.

[41] *See, e.g.*, Victorian Ry. Comm'r v. Coultas, 13 App. Cas. 222 (P.C. 1888). The "impact" not only was necessary to establish the tort action for trespass on the case, but it assured the court that damages of a physical nature were present, thus establishing the "piggyback" for the more subtle mental anguish or distress claims.

[42] *See* PROSSER § 55, at 350.

[43] *Id.* at 351. *See Recent Developments in North Carolina Statutory and Case Law—Torts*, 47 N.C.L. REV. 262, 280 (1968).

> The treatment of any element of damages as a parasitic factor belongs essentially to a transitory stage of legal evolution. A factor which is today recognized as parasitic will, forsooth, tomorrow be recognized as an independent basis of liability. It is merely a question of social, economic and industrial needs as those needs are reflected in the organic law.

PROSSER § 11, at 44 n.45 (quoting 1 T. STREET, FOUNDATIONS OF LEGAL LIABILITY 460, 470 (1906)). Although this transition has not completely occurred in the mental distress actions, courts will be more liberal in determining the basic physical injury to which the mental damages may attach where there is sufficient certainty that damages have resulted. *See, e.g.*, Crews v. Provident Fin. Co., 271 N.C. 684, 157 S.E.2d 381 (1967).

[44] *E.g.*, Tuttle v. Meyer Dairy Prod. Co., 100 Ohio App. 133, 138 N.E.2d 429 (1956) (plaintiff got a mouthful of broken glass, but received no cuts, and thus was denied recovery for his mental distress).

a subordinate loss of services often leads to an inequitable result when the only substantial damages are "parasitic."[45]

Even if the parasitic treatment of a negligent infliction of mental distress action may sometimes be justified on the basis of the subjective nature of the damages involved, there is no parallel justification for parasitic treatment of the consortium action. The consortium interests are obviously damaged when the marital relationship is disrupted because of an injury to the husband, just as the same consortium interests are damaged when there is an intentional interference[46] with the marital relations. The very nature of the consortium interests inherent in the legally recognized and protected marriage contract preclude any basis for fear of spurious claims.[47]

The absence of proximate cause is the fourth major argument advanced for denying the consortium action to the wife or either spouse.[48] Apparently the proximate causation problem was only recently discovered, for neither the common law courts nor those courts that allowed the husband to recover before the Married Women's Acts experienced difficulty in discerning proximate cause.[49] In fact, the courts that presently

[45] Courts allow recovery in circumstances especially likely to produce serious and genuine mental distress, without requiring an impact or resulting physical effects because there is little probability of a fictitious claim. *E.g.*, Russ v. Western Union Tel. Co., 222 N.C. 504, 23 S.E.2d 681 (1943) (recovery for mental distress caused by negligent transmission of a message announcing death).

[46] Sentimental elements are not treated as parasitic to loss of services in this type of consortium action because the damages to the marital relationship are obvious. But resulting physical damage is not required by most courts today as essential in an action for intentional infliction of mental distress, not because the damages are as obvious as those in an intentional interference with the marital relationship, nor because the damages are more obvious than those in an action for negligent infliction of mental distress, but because of the aggravated circumstances of the tort, which usually assure the court that damages are more probable and that there is less chance of a spurious claim.

[47] The requirement of a causal connection should not be confused with the need for proof that there have been damages in fact. Intangible damages are not treated as parasitic in intentional torts while the same type of damages are treated as parasitic in negligent torts because damages are more certain to follow. Whether a defendant has usurped the affections of plaintiff's husband or whether he has paralyzed her husband for life, the plaintiff-wife suffers an obvious loss of consortium.

[48] West v. San Diego, 54 Cal. 2d 469, 353 P.2d 929, 6 Cal. Rptr. 289 (1960); Gallagher v. Pequot Spring Water Co., 2 Conn. Cir. 354, 199 A.2d 172 (1963). *But see* Montgomery v. Stephan, 359 Mich. 33, 101 N.W.2d 227 (1960); Durham v. Gabriel, 16 Ohio App. 2d 51, 241 N.E.2d 401 (1968).

[49] *Compare* Bailey v. Long, 172 N.C. 661, 90 S.E. 809 (1916), *with* Hinnant v. Tide Water Power Co., 189 N.C. 120, 126 S.E. 307 (1925) *and* Helmstetler v. Duke Power Co., 224 N.C. 821, 32 S.E.2d 611 (1945).

allow only the husband the consortium action do not offer this argument against allowing the wife to recover in a mutual action.[50]

This reluctance to apply a proximate cause analysis is obviously based on a policy consideration against further extension of a defendant's liability for a single negligent act. Undoubtedly an incalculable influence on this policy determination is the fear of a future extension of a similar cause of action to other members of the family, especially the children, once the consortium action is allowed to either or both spouses.[51] However, the consortium interest should be confined to the unique relationship between the husband and wife, and not extended to the products of that relationship. While there are some similar interests within the parent-child relationship, such interests are less important and more temporary, as the child is expected eventually to leave his home and family.[52]

This policy determination on which the courts base their proximate cause argument becomes even less convincing when the defendant has committed a battery or other intentional tort on the husband or wife resulting in a loss of consortium to the other spouse.[53] The moral fault of the defendant should encourage the court to cast aside its fear of extending the defendant's liability in favor of a derivative consortium action in the spouse of the injured husband or wife.[54]

A useful analogy may once again be drawn to the development of an action for the negligent infliction of mental distress, although a sole action for the negligent,[55] or even intentional,[56] infliction of mental distress, unlike an action for loss of consortium, was not recognized at common law. The reasons offered for preventing the development of such an action were that the damages were too speculative and outside the boundaries of any reasonable "proximate" connection with

[50] Courts contending that a wife's loss of consortium is too remote from the defendant's negligent injury to her husband do not use a proximate cause analysis.

[51] *E.g.*, West v. San Diego, 54 Cal. 2d 469, 353 P.2d 929, 6 Cal. Rptr. 289 (1960).

[52] Neuburg v. Bobowicz, 401 Pa. 146, 160, 162 A.2d 662, 668 (1960) (dissenting opinion).

[53] *E.g.*, Smith v. United Constr. Workers, 271 Ala. 42, 122 So. 2d 153 (1960) (the defendant committed a battery on plaintiff's husband, but the court denied her an action for loss of consortium).

[54] There is a general attitude of the courts to impose greater responsibility upon an intentional wrongdoer, upon the obvious basis that it is better for losses caused by the defendant's act to fall upon the intentional wrongdoer than upon the innocent victim. PROSSER § 9, at 37.

[55] *Id.* § 55, at 346. *See, e.g.*, Lynch v. Knight, 11 Eng. Rep. 854 (1861).

[56] PROSSER § 11, at 41-42.

the defendant's act,[57] and were grounded in fear of unlimited liability in the defendant and a multiplicity of fictitious suits arising from the defendant's negligent or intentional act.[58] But these arguments have deterred few courts from recognizing independent mental distress actions, apart from any other tort involved in the defendant's act.

The final argument against an action in the wife for loss of consortium concerns the danger of double recovery.[59] Since the injured husband recovers for his own loss of services in his separate action for personal injury, any recovery by the wife for the loss of her husband's services in her consortium action would be a double recovery.[60] The court in *Millington v. Southeastern Elevator Co.*,[61] and two other courts,[62] have alleviated this danger of double recovery by requiring the wife to join her derivative consortium action with her husband's personal injury action. Thus, if the injured husband's action has been terminated either by judgment, settlement or otherwise, this would bar the wife's action for consortium.

Other courts that recognize reciprocal consortium actions in either spouse for an injury to the other spouse treat the consortium action as a separate and independent cause of action, which derives from the injured spouse's action.[63] Thus, the consortium action need not be joined with the injured spouse's suit, and a judgment in either action is not binding in the other action, nor does it bar recovery in the other action. The danger of double recovery is avoided by eliminating the loss of services element from the wife's consortium action. A special verdict may be employed to disclose any mistake by the jury in allowing the wife to recover for loss of her husband's services. No matter what procedure is followed in allowing either spouse the consortium action, all the courts treat the action as derivative of the injured spouse's action; thus, any defense

[57] *Id.* § 55, at 346-48.

[58] *Id.* at 351-52.

[59] It could be claimed that technically the husband is made "whole" again when he recovers for his injuries from the defendant; thus the wife could suffer no future loss of consortium. But such a fiction begs the question of whether the wife has suffered a loss of consortium in fact.

[60] *See, e.g.*, West v. San Diego, 54 Cal. 2d 469, 353 P.2d 929, 6 Cal. Rptr. 289 (1960); Millington v. Southeastern Elev. Co., 22 N.Y.2d 498, 239 N.E.2d 897, 293 N.Y.S.2d 305 (1968).

[61] 88 N.Y.2d 498, 239 N.E.2d 897, 293 N.Y.S.2d 305 (1968).

[62] Deems v. Western Md. Ry., 247 Md. 95, 231 A.2d 514 (1967); Ekalo v. Constructive Serv. Corp. of America, 46 N.J. 82, 215 A.2d 1 (1965).

[63] *E.g.*, State Farm Mut. Auto. Ins. Co. v. Jiles, 115 Ga. App. 193, 154 S.E.2d 286 (1967); Wolff v. Du Puis, 233 Ore. 330, 378 P.2d 707 (1963); Fitzgerald v. Meissner & Hicks, Inc., 38 Wis. 2d 571, 157 N.W.2d 595 (1968).

available to the defendant against the injured spouse is applicable to prevent recovery in the consortium action.[64]

An additional damages problem is that of evaluating the loss of consortium.[65] Admittedly, damages for loss of consortium are not readily subject to exact assessment, nor can any monetary recovery realistically replace the loss. However, courts refuse to allow similar problems to prevent recovery for loss of consortium when there has been an intentional interference with the plaintiff's marital relations; nor do the intangible aspects of the damages prevent evaluation of pain and suffering or mental distress in other tort actions.

A final argument in favor of the wife's recovery in those states that allow only the husband a consortium action is that this policy discriminates against the wife in violation of the equal protection clause of the fourteenth amendment.[66] In *Levy v. Louisiana*,[67] the Supreme Court held unconstitutional a Louisiana wrongful death statute forbidding a suit by illegitimate children for the wrongful death of their mother. The Court held that the "[l]egitimacy or illegitimacy of birth has no relation to the nature of the wrong allegedly inflicted on the mother,"[68] and that the

[64] *See, e.g.*, Tjaden v. Moses, 94 Ill. App. 2d 361, 237 N.E.2d 562 (1968); Patusco v. Prince Macaroni, Inc., 50 N.J. 365, 235 A.2d 465 (1967). Recovery for the loss of consortium is limited to the estimated life of the joint relationship after the injury. The diminution of the husband's life expectancy as a result of the injury is not significant. When the injured spouse dies, his action or right to recovery dies with him and is a valid defense against any recovery for loss of consortium after the husband's estimated time of death. In those states that allow the surviving spouse to recover consortium elements in a subsequent wrongful death action, where the actions can complement each other, the possibility of an inequitable recovery by the wife is slight. But in those states that allow the surviving spouse only a pecuniary loss recovery in a wrongful death action, there may be inequitable and conflicting results. *E.g.*, *compare* Walden v. Coleman, 105 Ga. App. 242, 124 S.E.2d 313 (1962) (wife allowed to bring a consortium action for the two hours that her husband survived his injury), *with* Lampe v. Lagomarcino-Grupe Co., 251 Iowa 204, 100 N.W.2d 1 (1959) (wife not allowed a consortium action for the hour that her husband survived his injuries).

[65] *See, e.g.*, West v. San Diego, 54 Cal. 2d 469, 353 P.2d 929, 6 Cal. Rptr. 289 (1960) (injury hard to express in monetary terms); Gallager v. Pequot Spring Water Co., 2 Conn. Cir. 354, 199 A.2d 172 (1963) (damages too speculative).

[66] *E.g.*, Owen v. Illinois Baking Corp., 260 F. Supp. 820 (W.D. Mich. 1966) (interpreting Indiana law); Durham v. Gabriel, 16 Ohio App. 2d 251, 241 N.E.2d 40 (1968). *But see* Miskunas v. Union Carbide Corp., 399 F.2d 847 (7th Cir. 1968) (Indiana law not an impermissible discrimination violative of the fourteenth amendment, but a permissible classification to prevent double recovery); Krohn v. Richardson-Merrell, Inc., 219 Tenn. 37, 406 S.W.2d 166 (1966), *cert. denied*, 386 U.S. 970 (1967) (not an impermissible discrimination but a permissible classification).

[67] 391 U.S. 68 (1968).

[68] *Id.* at 72.

statute, therefore, violated the equal protection clause. Like reasoning would seem applicable to those decisions that allow only the husband the consortium action. The court in *Millington* assumed that such a practice did violate the fourteenth amendment, but refused to base its opinion on a constitutional mandate. It chose instead considerations of policy and fairness.[69]

Ultimately, in deciding whether to allow the wife a cause of action for loss of consortium as a result of a negligent injury to her husband, there must be a balancing of interests. Although the wife may be indisputably deprived of the mutual consortium of her husband as a result of the negligent injury to him, to permit recovery the liability of a defendant must be extended. The realities and enlightment of our age, however, seem to weigh more heavily in favor of judicial recognition of the damage that can be done by a negligent defendant to the mutual rights within the unique consortium relationship.[70]

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[69] 22 N.Y.2d at —, 239 N.E.2d at 903, 293 N.Y.S.2d at 313.

[70] Note, *Husband and Wife, Parent and Child—Punitive Damages Disallowed In Husband's Cause of Action Arising Out of Injuries to His Wife and Minor Child*, 19 S.C.L. REV. 871 (1967) (punitive damages should not be allowed even if such damages are allowed the injured spouse). *See Note*, 28 U. PITT. L. REV. 366 (1966) (discussing the need for the mitigation of damages on behalf of the defendant where there is a lack of conjugal regard and affection between the spouses).