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Notes

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NOTES

Criminal Procedure—Federal Habeas Corpus For State Prisoners and the Fourth Amendment

Collateral attack on state criminal convictions in federal courts has long been a controversial subject. Those who favor limited collateral review are concerned with the need for finality in criminal proceedings, the burden placed on federal courts by the number of petitions, and the diminution of state responsibility and independence within the federal system. Those who advocate broad collateral review believe that these concerns are outweighed by the need for a procedure through which uniform enforcement of federal law is maintained and the need for a method of redressing incarcerations obtained in violation of the prisoner's rights. Since the early 1950's the number of grounds available to a petitioner seeking a writ of habeas corpus has increased. Indications are, however, that this trend is reversing.

In *Schneckloth v. Bustamonte*,[1] Justice Powell, in a concurring opinion, joined by two other Justices[2] and supported by a third,[3] wrote: "I would hold that federal collateral review of a state prisoner's Fourth Amendment claims . . . should be confined solely to the question of whether the petitioner was provided a fair opportunity to raise and have adjudicated the question in state courts."[4] The case involved the habeas corpus petition of a state prisoner who asserted that he was being held in violation of his fourth amendment rights. The state argued first that petitioner's rights had not been violated, and secondly, that the Court should reconsider its holding in *Kaufman v. United States*[5] and

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1. 412 U.S. 218 (1973).

2. Chief Justice Burger and Justice Rehnquist joined with Justice Powell in his concurring opinion. *Id.* at 250.

3. Justice Blackmun in a separate concurring opinion wrote: "Although I agree with nearly all that Mr. Justice Powell has to say in his detailed and persuasive concurring opinion, *post*, p. 250, I refrain from joining it at this time because, as Mr. Justice Stewart's opinion reveals, it is not necessary to reconsider *Kaufman* in order to decide the present case." *Id.* at 249.

4. *Id.* at 250 (Powell, J., concurring). Justice Stewart joined in a dissenting opinion written by Justice Harlan in Kaufman v. United States, 394 U.S. 217, 242-43 (1969), in which he stated that fourth amendment claims should be heard in collateral proceedings for federal prisoners only under limited circumstances. Thus it would appear that at least five members of the Court favor limiting review of fourth amendment claims to some extent.

5. 394 U.S. 217 (1969).

no longer allow fourth amendment claims to be asserted as a ground for federal habeas corpus relief.[6] The Court rejected petitioner's fourth amendment claims and declined to consider whether *Kaufman* should be overruled. [7] However, Mr. Justice Powell used this opportunity to express his views on the continued validity of *Kaufman*.[8]

BACKGROUND

The present rule is that fourth amendment claims, whether filed by state or federal prisoners, are cognizable in federal habeas corpus proceedings, and the trial court's application of the exclusionary rule must be examined as it would be on direct review.[9] The federal court is not bound by the state determination of the petitioner's claims and must hold its own evidentiary hearing if no adequate hearing on the issue was provided in the state courts. This rule has been codified,[10] but it is basically the product of three major cases.[11]

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6. Brief for Petitioner at 7-8, Schneckloth v. Bustamonte, 412 U.S. 218 (1973).

7. 412 U.S. at 249 n.38.

8. *Id.* at 250-51. It is necessary to point out at the outset that this is not the only attack on the scope of federal habeas corpus. Proposed Senate Bill 567, now in Senate committee, would restrict the grounds for federal habeas corpus to constitutional violations of only those rights which have as their primary purpose the protection of either the fact-finding process at the trial or the appellate process on appeal. S. 567, 93d Cong., 1st Sess. (1973). Thus, not only would fourth amendment violations no longer be cognizable, but also claims of violations of *Miranda* rights and *Wade* violations would be unreviewable in habeas proceedings. For an extensive treatment of this proposed bill see Note, *Proposed Modification of Federal Habeas Corpus for State Prisoners—Reform or Revocation*, 61 GEO. L.J. 1221 (1973).

9. Kaufman v. United States, 394 U.S. 217 (1969).

10. 28 U.S.C. § 2254(d) (1970). That subsection provides that the state determination of the facts is presumed to be correct unless it appears:

> (1) that the merits of the factual dispute were not resolved in the State court hearing;
> (2) that the fact-finding procedure employed by the State court was not adequate to afford a full and fair hearing;
> (3) that the material facts were not adequately developed at the State court hearing;
> (4) that the State court lacked jurisdiction of the subject matter or over the person of the applicant in the State court proceeding;
> (5) that the applicant was an indigent and the State court, in deprivation of his constitutional right, failed to appoint counsel to represent him in the State court proceeding;
> (6) that the applicant did not receive a full, fair and adequate hearing in the State court proceeding; or
> (7) that the applicant was otherwise denied due process of law in the State court proceeding;
> (8) or unless that part of the record of the State court proceeding in which the determination of such factual issue was made, pertinent to a determination of the sufficiency of the evidence to support such factual determination, is produced as provided for hereinafter, and the Federal court on a consideration of such part of the record as a whole concludes that such factual determination is not fully supported by the record. . . .

11. *See* Kaufman v. United States, 394 U.S. 217 (1969); Fay v. Noia, 372 U.S.

In the landmark case of *Brown v. Allen*,[12] the Supreme Court held that claims of constitutional violations would present valid grounds for federal habeas corpus even if the state courts had fairly and fully adjudicated them. Mr. Justice Frankfurter, in a concurring opinion wrote, "The State court cannot have the last say when it, though on fair consideration and what procedurally may be deemed fairness, may have misconceived a federal constitutional right."[13] Implicit in the opinion is a recognition that habeas corpus provides a procedural device through which federal rights are vindicated and state enforcement of those rights is supervised.[14]

In *Fay v. Noia*[15] this recognition was more formally expressed. Justice Brennan, writing for the Court, saw as the basic purpose of habeas corpus the vindication of due process rights.[16] To the Court "[i]ts root principle is that . . . government must always be accountable to the judiciary for a man's imprisonment . . . ."[17] Federal habeas corpus was seen as an established procedure which provides a remedy for any restraint considered to be contrary to fundamental rights. Thus as due process rights evolve and expand, the writ becomes available as a remedy for the violation of those rights.

In *Fay* the Court did not expressly rule that claims of fourth amendment violations would be cognizable in federal habeas corpus proceedings. The underlying rationale, however, was that habeas corpus was

391 (1963); Brown v. Allen, 344 U.S. 443 (1953). The rule could possibly be considered to be the outgrowth of four major cases with the inclusion of Townsend v. Sain, 372 U.S. 293 (1969), discussed *infra* note 17.

12. 344 U.S. 443 (1953).

13. *Id.* at 508.

14. *See Developments in the Law—Federal Habeas Corpus*, 83 HARV. L. REV. 1038, 1061-62 (1970) [hereinafter cited as *Developments*]. At the time of the *Brown* decision the exclusionary rule was not applicable to the states and thus was not a part of the due process rights to be protected. However at the time of the *Fay* decision *Mapp v. Ohio* had been decided.

15. 372 U.S. 391 (1963). In this habeas corpus proceeding the Court considered a state prisoner's claim that his confession was coerced, even though the prisoner had not directly appealed to the state appellate court within the applicable time period. The Court held that the requirement that a state prisoner must exhaust his state remedies before applying for a writ meant only that the prisoner must exhaust the state remedies remaining available to him at the time of the filing of the habeas petition.

16. *Id.* at 402.

17. *Id.* In Townsend v. Sain, 372 U.S. 293, 312-19 (1963), decided the same day as *Fay*, the Court set down guidelines that the district courts should follow in deciding whether to grant an evidentiary hearing in a habeas corpus proceeding. It was made clear that the court could not automatically accept the state determination of facts and that in all situations it was the duty of the federal judge to apply independently the federal law. Such a holding has added significance in the fourth amendment area because in such claims the law and fact are often intertwined.

available as a remedy for any violation of due process. At the time of the decision, the fourth amendment and its exclusionary rule had been applied to the states through the due process clause of the fourteenth amendment.[18] Several later cases made it clear that a state prisoner's fourth amendment claims could properly be heard in federal habeas corpus proceedings.[19]

A conflict developed in the circuits, however, with regard to whether a federal[20] prisoner could raise such claims collaterally.[21] A majority of the circuits held that they could not because collateral relief was not meant to take the place of direct appeal.[22] The rationale for this holding was best expressed in *Thornton v. United States.*[23] In that case the District of Columbia Circuit reasoned that, unlike other constitutional violations, the claims of illegal search and seizure do not impugn the integrity of the fact-finding process, nor do they challenge the evidence as being inherently unreliable.[24] Thus, the court reasoned, the enforcement of the exclusionary rule is meant solely as a deterrent device.[25] The court felt that since deterrence is not furthered by enforcement of the rule in post-conviction proceedings, fourth amendment claims should not be available to a federal prisoner seeking collateral relief.[26] To distinguish this position from that of the state prisoners,

18. Mapp v. Ohio, 367 U.S. 643, 655 (1961).

19. Carafas v. Lavallee, 391 U.S. 234 (1968); Warden v. Hayden, 387 U.S. 294 (1967). In these cases state prisoners raised fourth amendment claims through habeas corpus, and the Court decided those claims on the merits without a full discussion of the appropriateness of habeas corpus for raising them.

20. It is the purpose of this note to analyze the issues involved when a state prisoner asserts fourth amendment violations in a federal court. This is a separate problem from that of a federal prisoner who collaterally attacks his conviction on the same grounds, and different considerations are involved. The discussion of the cases involving the availability of collateral attack for federal prisoners asserting fourth amendment violations is helpful however, because those cases reveal the reasoning behind the Court's holdings in the cases which do involve state prisoners. In *Schneckloth* Justice Powell, in his concurring opinion, was primarily concerned with the availability of the writ for state prisoners asserting fourth amendment claims, however he recognized that *Kaufman* dealt mainly with federal prisoners. 412 U.S. at 250-51.

21. The existence of this conflict was recognized in Kaufman v. United States, 394 U.S. 217, 219-21 (1969).

22. *E.g.*, United States v. Re, 372 F.2d 641, 644 (2d Cir. 1967); Springer v. United States, 340 F.2d 950 (8th Cir. 1965) (per curiam).

23. 368 F.2d 822 (D.C. Cir. 1966). The *Thornton* case did not rule out fourth amendment claims completely but said they could be heard only in exceptional circumstances. *Id.* at 826-29. In *Kaufman* the government adopted the reasoning of this opinion and pressed its arguments before the Supreme Court. Kaufman v. United States, 394 U.S. 217, 224-25 (1969).

24. 368 F.2d at 827-28.

25. *Id.* at 826-28.

26. *Id.*

who were allowed to raise fourth amendment claims, the court pointed to the necessity for adjudication of the state prisoner's claims in a federal forum.[27]

In *Kaufman v. United States*[28] the Supreme Court held that federal prisoners could assert fourth amendment violations collaterally and reaffirmed the availability of federal habeas corpus to state prisoners who assert fourth amendment claims. The Court rejected the argument that such relief was available to state prisoners solely because of the need for a federal determination of their claims. The Court stated that the availability of federal habeas corpus to state prisoners who assert fourth amendment violations was premised largely "on a recognition that the availability of collateral remedies is necessary to ensure the integrity of the proceedings at and before trial where constitutional rights are at stake."[29] The Court argued that collateral relief "contributes to the present vitality of constitutional rights whether or not they bear on the integrity of the fact-finding process."[30] The argument that the scope of federal habeas corpus should be curtailed by the need for finality was rejected.[31]

THE OPINION

Justice Powell begins his opinion by briefly reviewing the history of habeas corpus. He concludes that recent decisions have transcended the traditional purpose of habeas corpus and have diminished the importance of finality in state criminal judgments.[32] He identifies the purpose of the writ as the prevention and redress of "unjust" incarcerations.[33] To him "unjust" incarceration refers to the imprisonment of innocent people,[34] not to the imprisonment of those people who are in fact guilty but whose convictions were obtained in violation of their constitutional rights. Since many prisoners who assert fourth amendment violations are not innocent in fact,[35] Justice Powell concludes that they

27. *Id.* at 828-29.
28. 394 U.S. 217 (1969).
29. *Id.* at 225.
30. *Id.* at 229.
31. *Id.* at 228. The Court also had occasion to mention the exclusionary rule, saying that its enforcement could not depend upon the guilt or innocence of the person on trial. The exclusionary rule was seen rather as necessary to the protection of all citizens from unreasonable searches and seizures. *Id.* at 229.
32. 412 U.S. at 256.
33. *Id.* at 257-58.
34. *Id.*
35. *Id.* Arguments could possibly be made against Justice Powell's assertion that prisoners who assert fourth amendment claims are rarely innocent. However, it is the

are not unjustly incarcerated and, federal habeas corpus should not be available to them.[36]

Justice Powell then examines the societal costs of collateral review of fourth amendment claims.[37] He argues that collateral attacks constitute an unwise allocation of judicial resources.[38] When such reviews are made, federal courts needlessly duplicate the efforts of the state judiciary. Also habeas corpus petitions place a time consuming burden on the federal courts that deprives civil litigants of prompt adjudication of their claims. A second cost he identifies is the near total defeat of society's interest in a rational point of termination for criminal litigation.[39] Society, he argues, can no longer afford to constantly re-examine every conviction to insure the absence of constitutional error. This practice defeats the deterrent effect of the criminal law by making slow and uncertain the prospect of punishment for the convicted defendant. In Justice Powell's view, the present scope of collateral review also prevents effective rehabilitation by encouraging the prisoner to try to overturn his conviction rather than to admit his guilt. A third cost Justice Powell identifies is the imbalance within the federal system created by the present scope of habeas corpus, which places upon the federal courts a disproportionate share of the responsibility for adjudicating federal claims.[40] This imbalance works to decrease the respect accorded the state courts and leads to tension between state and federal judicial systems.

Having assessed the societal costs of extending federal habeas corpus to include fourth amendment claims, Justice Powell then examines the societal benefits it provides.[41] He frames his analysis in terms of the exclusionary rule, which, he asserts, has deterrence as its sole purpose.[42] He feels that this purpose is not significantly furthered by collateral enforcement of the exclusionary rule because such enforcement is too far removed from the everyday activities of law enforcement officers. At this point Justice Powell feels that the evils of the exclusionary rule

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purpose of this note to explore the question of whether collateral review of fourth amendment claims is justified even if we assume the petitioner is guilty. As will be discussed later, habeas corpus procedure has come to serve functions which are independent of the question of guilt or innocence.

36. *Id.*
37. *Id.* at 259-66.
38. *Id.* at 260-61.
39. *Id.* at 261.
40. *Id.* at 263.
41. *Id.* at 266-67.
42. *Id.* at 266-68.

more than outweigh its benefits.[43] He also argues that since the habeas proceedings generally involve close and intricate problems that pose difficulties for the courts and that are beyond the understanding of many policemen, the deterrent aspect of the rule is not furthered by adjudication of these issues.[44]

AN ANALYSIS

These arguments, though convincing, do not present an impregnable attack on the scope of federal habeas corpus. The major weakness of the opinion lies in the assertion that the purpose of the writ is to prevent incarceration of innocent people. Historically, the writ involved more than the question of innocence.[45] Justice Powell's assertion ignores the role federal habeas corpus has played in vindicating due process rights and ensuring that the states adequately enforce them.[46] In a slight and inadequate concession to this role, he reserves to the federal courts the power to examine the record in order to determine whether the prisoner has been given a fair opportunity to raise his claims.[47] This concession may in one sense prevent the incarceration of innocent people by ensuring that the opportunity to raise fourth amendment claims is available. However, if one assumes, as Justice Powell does, that those who assert such claims are usually guilty, then the concession is inconsistent with the purpose he proposes for the writ. The adjudication of claims asserted by guilty persons would do nothing to prevent the incarceration of the innocent.

By proposing that the federal courts be removed from the consideration of the merits of state prisoners' fourth amendment claims, Justice Powell fails to acknowledge the important functions those courts perform. First, the federal courts provide a separate and a federal

43. *Id.* at 269.

44. *Id.*

45. *Id.* at 257. Justice Powell is aware of this fact but feels that in light of present demands on the judicial system, tying the writ to guilt or innocence is justified.

46. Vindication of due process rights is a recognized purpose of federal habeas corpus. *See, e.g.*, Fay v. Noia, 372 U.S. 391, 402 (1963); Wright & Sofaer, *Federal Habeas Corpus for State Prisoners: The Allocation of Fact-Finding Responsibility*, 75 YALE L.J. 895, 895-96, 958-85 (1966); Note, 61 GEO. L.J., *supra* note 8, at 1229-30; *Developments, supra* note 14, at 1060-63. Respondent Bustamonte pressed these arguments in his brief arguing that historically the expansion of grounds for federal habeas corpus has corresponded to the evolving standards of due process. He also urged that there is a great need for uniform application of federal law. Brief for Respondent at 22-35, Schneckloth v. Bustamonte, 412 U.S. 218 (1973) [hereinafter cited as Respondent's Brief].

47. 412 U.S. at 250.

forum, isolated from the question of guilt, in which the sole issue is whether the prisoner's rights were violated.[48] Such a forum is necessary because the closeness of state judges to the enforcement of state substantive law may unconsciously affect their disposition of the constitutional claims.[49] Another major advantage of federal courts is their capacity to supervise state court determinations to ensure uniform enforcement of federal law.[50] Access to federal adjudication would otherwise not be possible in many cases on direct review because of the small number of writs of certiorari granted by the Supreme Court.[51] The federal courts relieve the Supreme Court's caseload in this regard, and the habeas cases that do eventually reach the high court usually contain evidence not found in the often incomplete records available to the Supreme Court on direct review.[52] Such functions are important in fourth amendment claims because the factual findings are often determinative of the legal question presented in the case.

Justice Powell's argument that the present scope of federal habeas corpus places an unduly heavy burden on the federal courts and is an unwise allocation of judicial resources is also unconvincing. Federal courts allocate relatively little time to habeas corpus petitions[53] and rarely require extensive evidentiary hearings since most of the petitions are decided at the pleading stage.[54] The prisoner is seldom successful, and only a small number of state retrials are required.[55] Also, in recent years the number of petitions filed has begun to decrease.[56] Assuming

48. *Developments, supra* note 14, at 1057-61.

49. Respondent's Brief at 29-30; Note, 61 GEO. L.J., *supra* note 8, at 1251; *Developments, supra* note 14, at 1057-61.

50. Wright & Sofaer, *supra* note 46, at 897-98; Note, 61 GEO. L.J., *supra* note 8, at 1226; *see Developments, supra* note 14, at 1061-62.

51. *See* Fay v. Noia, 372 U.S. 391, 437 (1963); Wright & Sofaer, *supra* note 46, at 897 n.11; Note, 61 GEO. L.J., *supra* note 8, at 1251.

52. Fay v. Noia, 372 U.S. 391, 438 (1963); Wright and Sofaer, *supra* note 46, at 897.

53. Note, 61 GEO. L.J., *supra* note 8, at 1246.

54. LaFrance, *Federal Habeas Corpus and State Prisoners: Who's Responsible?* 58 A.B.A.J. 610, 612 (1972).

55. *Id.* 1971 DIRECTOR OF ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS ANNUAL REPORT 132 shows that in about ninety-six percent of the prisoner petition cases the relief prayed for was not granted. This does not mean that the remedy is unnecessary, however. The value of habeas corpus is that it is a procedural device which insures state compliance with due process rights. Its value can not be assessed in terms of the number of state retrials granted for that would assume that if habeas corpus were removed the state would be as careful as they now are in enforcing federal rights.

56. In fiscal 1970 state prisoners filed 9,063 petitions for writs of habeas corpus in federal district courts. In fiscal 1971 the number was 8,372 and in fiscal 1972, 7,949. 1972 DIRECTOR OF ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS

however that habeas petitions do constitute a heavy burden on the courts, there are alternative means to relieve the burden that do not remove the protection provided to the fourth amendment by habeas corpus. These include using standardized forms, referring the petitions to federal magistrates, and, more importantly, providing the state prisoner with counsel to aid him in presenting his claim in a more efficient manner.[57] The ultimate solution is for the states themselves to provide post-conviction proceedings that emphasize adjudication on the merits.[58] Justice Powell's solution would create an even greater misallocation of judicial resources, for if federal courts are precluded from examining the merits of fourth amendment claims, the Supreme Court may be pressured into granting more writs of certiorari in order to ensure state compliance with and uniform enforcement of federal law.

Contrary views also exist on Justice Powell's contention that the present scope of federal habeas corpus significantly diminishes the value of the finality of state convictions.[59] The present habeas procedure makes several concessions to that interest in its operation and practical effect. First, section 2254 establishes the presumption that the state hearings have been adequate and casts the burden of proving deficiencies upon the petitioner.[60] Second, except for sufficiency of evidence claims, federal habeas corpus does not purport to relitigate the question of guilt or innocence, but is restricted to constitutional claims and violations of federal laws.[61] Third, state convictions are rarely overturned.[62] Finally, district courts may refuse to hear the petition if the petitioner has voluntarily waived his claim in the state proceeding.[63]

Arguments that habeas corpus does not create undue friction between state and federal courts have been made. The habeas procedure presently reduces this tension since the prisoner must exhaust his state

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ANNUAL REPORT Table 19, at 117. The report suggests that the reasons for the decline are improvements in state post conviction remedies and the availability of counsel for the indigent defendant. The decline is expected to continue. *Id.* at 116. Justice Powell notes this decrease but does not consider it significant enough to relieve the burden.

57. United States v. Simpson, 436 F.2d 162, 166-70 (D.C. Cir. 1970); Shapiro, *Where Have All the Lawyers Gone?*, 9 TRIAL No. 3, 41 at 42 (1973).

58. *See* LaFrance, *supra* note 54, at 613.

59. The Court in *Fay* and in *Kaufman* felt that the traditional concerns for finality should not be allowed to outweigh the federal policy behind vindicating constitutional rights. The argument concerning finality is not a new one, but it has increased importance because of the value placed upon it by several members of the present Court.

60. 28 U.S.C. § 2254(d) (1970), *quoted in* note 10 *supra.*

61. LaFrance, *supra* note 54, at 612.

62. *See* notes 55-56 *supra.*

63. Fay v. Noia, 372 U.S. 391, 438-40 (1963).

remedies prior to application for a writ, thereby giving the state courts an opportunity to correct their mistakes.[64] Further, friction between the two systems may not be inevitable.[65] Friction may be primarily a function of the individual judge's psychology, and thus to a large extent could be overcome subjectively.[66] There are, in addition, institutional alternatives for relieving friction that do not require the limitation of the scope of federal habeas corpus.[67] These alternatives seek to relieve friction by reducing the total number of petitions and by improving the co-operation and communication between the federal and state judges.

Also, it must be noted that the solution proposed by the opinion has the potential to create even more friction. By asking whether the state has provided an adequate opportunity to have the claim heard, friction is not alleviated, rather it is created at a different point in the system. For example, when a federal judge is presented with a claim that he feels the state court has wrongly decided, but he is convinced that the court provided an adequate hearing, he would face a problem the solution of which would necessarily create tension. If he denies the writ, his own decision is in conflict with his perception of the federal right. If the federal judge grants the petition, his decision informs state judges that not only have they misconceived a federal right, but they have also failed to provide an adequate opportunity for the right to be heard. This solution would seemingly create more tension than the mere reversal of the state court's decision. Also, much of the friction, which Justice Powell feels habeas corpus creates, is not caused by habeas corpus but rather by disagreement with the federal right asserted by the petitioner.

Arguments may also be presented against the position that there is little value in enforcing fourth amendment claims in a federal habeas

64. Wright & Sofaer, *supra* note 46, at 902-03. The authors also suggest that the requirements that the petitioner assert a non-frivolous claim, the petitioner be in custody, and the petitioner not be detained on other adequate grounds, all work to relieve the tension between the systems. *Id.*

65. Hopkins, *Federal Habeas Corpus: Easing the Tension Between State and Federal Courts*, 44 ST. JOHN'S L. REV. 660, 670 (1970).

66. Freund, *Remarks at Symposium of Federal Habeas Corpus*, 9 UTAH L. REV. 27, 30 (1964).

67. These alternatives include: (1) having the state courts briefly state the claims of the prisoner and the reasons for their denial; (2) establishing a data bank which would contain the record of all applications of each prisoner in each system; (3) giving recognition to the state courts' function as factfinders by holding evidentiary hearings in state courts; (4) reducing the number of petitions by denying retroactive effect to newly evolved standards of due process; (5) having an open system of communication between the two systems. Hopkins, *supra* note 65, at 670-75.

corpus proceeding. First, it cannot be so readily assumed that the exclusionary rule's sole function is to deter.[68] One of the reasons the Court gave for its application to the states was to ensure the integrity of the judicial process.[69] There was a desire to ensure that the courts would not sanction illegal government activity by admitting illegally seized evidence. Secondly, enforcement of the exclusionary rule in habeas corpus proceedings does provide additional support for the rule's deterrent effect.[70] By keeping in the minds of the attorneys and state judges that what they are doing is subject to a likelihood of federal court review, they will be more likely to handle those claims with added care and respect. Thus by inducing the attorneys and trial judges to maintain high standards in dealing with police conduct and fourth amendment claims, the deterrent aspect of the rule is strengthened.

CONCLUSION

The concurring opinion in *Schneckloth v. Bustamonte* is a covert attack on the exclusionary rule. If the views expressed in the opinion are carried to their logical conclusion and habeas corpus is restricted to only those constitutional claims that affect the determination of guilt and the reliability of the fact-finding process, habeas corpus will have lost its place as the procedural device for the vindication of due process rights. Uniform enforcement of constitutional rights will be hampered while no significant improvement in federal and state relations will occur. Though the opinion does not reflect present law, it does indicate that the Supreme Court, as currently composed, is dangerously close to curtailing the scope of federal habeas corpus.

E. G. WALKER

68. The Court in *Kaufman* recognized that collateral review serves to secure the integrity of the proceeding whether or not the constitutional right bears on the reliability of the factfinding process. 394 U.S. at 229. It has been suggested too that the rule gives opportunities for judicial review demonstrating the importance of the constitutional right it protects. *See* Note, 61 GEO. L.J., *supra* note 8, at 1232.

69. Mapp v. Ohio, 367 U.S. 643, 659 (1961).

70. The *Kaufman* Court found it necessary to enforce the exclusionary rule collaterally saying that the rule was necessary to protect all citizens from unreasonable searches and seizures. The Court also distinguished enforcement of the rule collaterally from the denial of retroactive effect to the rule, finding that collateral enforcement added to the integrity of the proceedings at and before trial while retroactive effect did not. 394 U.S. at 229; *see* Freund, *supra* note 66, at 30; Note, 61 GEO. L.J., *supra* note 8, at 1251-52.

Criminal Procedure—Standards for Valid Consent to Search

A warrantless search is reasonable under the fourth amendment only within a few "specifically established and well delineated exceptions."[1] Most of these exceptions are based upon the necessity of immediate police action where the requirement of a warrant would severely hamper effective law enforcement or threaten the safety of police officials.[2] The exception based upon consent has not been so well delineated although it is settled that it is based not on exigent circumstances but upon the theory that anyone may cooperate with law enforcement officials and that such cooperation should be encouraged.[3] The question of when a consent to search is validly given has until recently been a matter of dispute among state and federal courts.[4]

The United States Supreme Court has formulated the test for a valid consent in *Schneckloth v. Bustamonte*.[5] Denying that a defendant's knowledge of his right to withhold consent was a prerequisite for a valid search, the Court held "that when the subject of a search is not in custody and the State attempts to justify the search on the basis of his consent, the Fourth and Fourteenth Amendments require that it demonstrate that the consent was in fact voluntarily given, and not the result of duress or coercion, express or implied."[6]

Schneckloth involved the search of an automobile based entirely upon consent. The respondent, Robert Bustamonte, and five companions were stopped by a police officer on routine patrol because of a nonfunctioning headlight and license plate light. The driver, Joe Gonzales, failed to produce a valid operator's license and only Joe Alcala, who explained that the car belonged to his brother, could produce a license. The officer asked the six occupants to step out of the car, and after the arrival of two additional officers, he asked Alcala if he could search the car. Alcala replied, "Sure, go ahead." No one had been arrested, and the atmosphere was described by the officers and

1. Katz v. United States, 389 U.S. 347, 357 (1967).
2. *See, e.g.*, Coolidge v. New Hampshire, 403 U.S. 443 (1971); Chimel v. California, 395 U.S. 752 (1969).
3. *See* text accompanying note 58 *infra*.
4. *Compare, e.g.*, Wren v. United States, 352 F.2d 617 (10th Cir. 1965), *and* Higgins v. United States, 209 F.2d 819 (D.C. Cir. 1954), *with* Lucas v. State, 368 S.W.2d 605 (Tex. Crim.), *cert. denied*, 375 U.S. 925 (1963). *See also* notes 12-13 *infra*.
5. 412 U.S. 218 (1973).
6. *Id.* at 248-49.

Gonzales as "congenial". Alcala assisted in the search by opening the trunk of the car. Under the rear seat the officers found three crumpled checks which had been stolen from a car wash. Only then were the men arrested.

The respondent was convicted of possession of a check with intent to defraud. The conviction was affirmed on appeal,[7] and the California Supreme Court denied review.[8] But the Ninth Circuit Court of Appeals, vacating a district court's denial of a writ of habeas corpus, remanded for a determination of whether Alcala had known of his fourth amendment right to withhold his consent to the search.[9] The United States Supreme Court, in an opinion by Mr. Justice Stewart, held that, while the defendant's knowledge of his rights is one of the facts to be considered, it is not an essential element of an effective consent. Rather, the determination must focus on the voluntariness of the consent, considering all the surrounding circumstances. Therefore, the Court reasoned, the inquiry thought necessary by the court of appeals was not required.[10]

Prior to *Schneckloth* there was conflict among the lower courts, as illustrated by that of the California courts and the Ninth Circuit. The courts of California applied the voluntariness test as formulated by Justice Traynor in *People v. Michael*:[11] "Whether in a particular case an apparent consent was in fact voluntarily given or was in submission to an express or implied assertion of authority, is a question of fact to be determined in the light of all the circumstances."[12] This test is primarily concerned with the actions of the police in eliciting the consent and requires a determination of whether there had been coercion or duress involved.

The Ninth Circuit, on the other hand, approached the issue by considering consent a waiver of fourth and fourteenth amendment rights. This test primarily focused on the state of the defendant's knowledge. It not only required a showing of voluntariness by the

7. People v. Bustamonte, 270 Cal. App. 2d 648, 76 Cal. Rptr. 17 (1969).
8. The order of the Supreme Court of California is unreported.
9. Bustamonte v. Schneckloth, 448 F.2d 699 (9th Cir. 1971).
10. 412 U.S. at 248-49.
11. 45 Cal. 2d 751, 290 P.2d 852 (1955).
12. *Id.* at 753, 290 P.2d at 854; *see* United States v. Smith, 308 F.2d 657 (2d Cir. 1962), *cert. denied*, 372 U.S. 906 (1963); United States v. Perez, 242 F.2d 867 (2d Cir.), *cert. denied*, 354 U.S. 941 (1957); People v. Tremayne, 20 Cal. App. 3d 1006, 98 Cal. Rptr. 192 (1971); State v. Hauser, 257 N.C. 158, 125 S.E.2d 389 (1962) (per curiam).

state but also an affirmative showing that the defendant had knowledge of his right freely and effectively to withhold his consent.[13]

In upholding the California approach, the Court in *Schneckloth* adopted the reasoning of cases involving coerced confessions that were decided prior to *Escobedo v. Illinois*.[14] In those cases the due process balancing of individual liberty against the security of society was reached by use of the voluntariness test, that is whether, judging from the "totality of the circumstances," the confession was "the product of an essentially free and unconstrained choice by its maker."[15] Applying these standards to consent searches, the Court concluded that the waiver approach of the Ninth Circuit was inappropriate.[16]

This resolution of the conflict has some basis in a few early cases concerning consent searches, although it was by no means compelled by precedent. The consent search has been recognized at least since *Davis v. United States*[17] in which the Court upheld the search of a gasoline station storeroom on the basis of the defendant's consent.

The Court focused, however, on the public nature of the gas rationing coupons that were the objects of the search and avoided the question of consent in the more usual case of *private* documents.[18] Al-

13. "Such a waiver cannot be conclusively presumed from a verbal expression of assent. The Court must determine from all the circumstances whether the verbal assent reflected an understanding, uncoerced, and unequivocal election to grant the officers a license which the person knows may be freely and effectively withheld." Cipres v. United States, 343 F.2d 95, 97 (9th Cir. 1965); *see* United States v. Mapp, 476 F.2d 67 (2d Cir. 1973); Schoepflin v. United States, 391 F.2d 390 (9th Cir.), *cert. denied*, 393 U.S. 865 (1968); Rosenthall v. Henderson, 389 F.2d 514 (6th Cir. 1968); United States v. Nikrasch, 367 F.2d 740 (7th Cir. 1966); State v. Witherspoon, 460 S.W.2d 281 (Mo. 1970). *But see* Martinez v. United States, 333 F.2d 405 (9th Cir. 1964).

14. 378 U.S. 478 (1964). *Escobedo* marked the initial shift from subjective voluntariness to a more objective inquiry into whether the defendant had in fact been advised of his rights. The shift was completed two years later in Miranda v. Arizona, 384 U.S. 436 (1966); *see* text accompanying note 28 *infra*.

15. 412 U.S. at 225, *quoting* Culombe v. Connecticut, 367 U.S. 568, 602 (1961).

16. [W]e cannot accept the position of the Court of Appeals in this case that proof of knowledge of the right to refuse consent is a necessary prerequisite to demonstrating a "voluntary" consent. Rather it is only by analyzing all the circumstances of an individual consent that it can be ascertained whether in fact it was voluntary or coerced. It is the careful sifting of the unique facts and circumstances of each case that is evidenced in our prior decisions involving consent searches.

412 U.S. at 232-33.

17. 328 U.S. 582 (1946). In an earlier case the Court hinted that consent might be a valid exception to the warrant requirement in some instances when it curtly rejected the contention that the consent involved in that case operated as a valid waiver. Amos v. United States, 255 U.S. 313 (1921).

18. We do not stop to review all of our decisions which define the scope of "reasonable" searches and seizures. For they have largely developed out of cases involving the seizure of *private* papers. We are dealing here not

though the Court appeared to examine the surrounding circumstances and spoke in terms of voluntariness,[19] the precedential value of *Davis* proved to be merely in establishing that consent is a valid exception to the warrant requirement.[20] The standards for determining when a particular consent is valid were not clearly explained and consequently became a question for lower courts.

In *Davis* the Court did not refer to the concept of waiver, although this concept had been developed earlier in the context of the sixth amendment right to counsel. In *Johnson v. Zerbst*,[21] the Court spoke of the waiver of a constitutional right in general terms. "A waiver is ordinarily an intentional relinquishment or abandonment of a known right or privilege."[22] This standard was accepted and applied by the Court in areas other than the right to counsel,[23] and two years after *Davis* the Court invalidated a consent search using the language of the waiver standard. In *Johnson v. United States*[24] the Court said, "It [entry into defendant's hotel room] was granted in submission to authority rather than as an *understanding and intentional waiver* of a constitutional right."[25] The seed for conflict as to the applicable standard for determining the validity of consent was planted here.

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with *private* papers or documents, but with gasoline rationing coupons which never became the property of the holder but remained at all times the property of the government and subject to inspection and recall by it.
328 U.S. at 587-88.

19. In a companion case the Court upheld a search "consented" to by contract. The Court held that "those rights [under the fourth and fourteenth amendments] may be waived. And when petitioner . . . specifically agreed to permit inspection of his accounts and records, he voluntarily waived such claim to privacy which he otherwise might have had . . . ." Zap v. United States, 328 U.S. 624, 628 (1946).

20. Zap v. United States, 328 U.S. 624 (1946), is cited by the American Law Institute for this proposition rather than as authority for the voluntariness test of consent. The ALI did not mention *Davis* but concluded that "voluntariness is not enough; effective consent requires awareness as well." ALI MODEL CODE OF PRE-ARRAIGNMENT PROCEDURE, *Commentary* at 192 (Proposed Official Draft No. 1, 1972) [hereinafter cited as MODEL CODE].

21. 304 U.S. 458 (1938).

22. *Id.* at 464.

23. *See, e.g.*, Barker v. Wingo, 407 U.S. 514 (1972) (speedy trial); McMann v. Richardson, 397 U.S. 759 (1970) (guilty plea); Barber v. Page, 390 U.S. 719 (1968) (right of confrontation); Brookhart v. Janis, 384 U.S. 1 (1966) (same); Green v. United States, 355 U.S. 184 (1957) (double jeopardy); Adams v. United States *ex rel.* McCann, 317 U.S. 269 (1942) (jury trial). The right to counsel and the *Zerbst* waiver standard were extended in United States v. Wade, 388 U.S. 218 (1967) (post-indictment pre-trial lineup); *In re* Gault, 387 U.S. 1 (1967) (juvenile proceeding).

24. 333 U.S. 10 (1948).

25. *Id.* at 13 (emphasis added). *Johnson* was distinguished as involving "implied" consent in a case upholding a search based upon "express" consent which the court concluded was "knowingly made." United States v. MacLeod, 207 F.2d 853, 856 (7th Cir. 1953).

That seed did not begin to grow, however, until the mid-Sixties when the waiver standard was extended to the fifth amendment, which had long been under the exclusive protection of the voluntariness test.[26] In *Miranda v. Arizona*[27] the privilege against self incrimination came under the additional protection of the rigid waiver requirements.[28] A few lower courts almost immediately held that *Miranda* compelled application of the waiver standard to consent searches and that specific warnings of fourth amendment rights were required before obtaining the consent of a subject.[29] Most courts rejected the proposition that such warnings were required, although some continued to apply the knowing waiver standard to the fourth amendment.[30]

The Supreme Court had the opportunity to resolve the conflict among the courts on this issue in *Bumper v. North Carolina*.[31] The alleged consent was given by the black defendant's sixty-six year-old grandmother to four white police officers claiming authority to search under a warrant.[32] Conspicuously absent from Mr. Justice Stewart's majority opinion was any mention of the word "waiver."[33] Instead the majority held the search invalid on the basis of the claim of authority: "When a prosecutor seeks to rely upon consent to justify the lawfulness of a search, he has the burden of proving that the con-

26. Escobedo v. Illinois, 378 U.S. 478 (1964); *see* note 14 *supra*. The shift from voluntariness to waiver during this period is well illustrated by the Ninth Circuit cases: Martinez v. United States, 333 F.2d 405 (9th Cir. 1964) (voluntariness); Cipres v. United States, 343 F.2d 95 (9th Cir. 1965) (waiver).

27. 384 U.S. 436 (1966).

28. *Miranda* abandoned "a long history of judicial review of the validity of confessions under the vague and subjective test of the due process clause, substituting therefor a rigidly specific and objective standard founded on the fifth amendment's self-incrimination provision." Note, *Consent Searches: A Reappraisal After Miranda v. Arizona*, 67 COLUM. L. REV. 130, 133 (1967).

Significantly, the *Miranda* Court cites *Zerbst*, noting that it "has always set high standards of proof for the waiver of constitutional rights," and that it "re-assert[s] these standards as applied to in-custody interrogation." 384 U.S. at 475.

29. *E.g.*, United States v. Nikrasch, 367 F.2d 740 (7th Cir. 1966); United States v. Moderaki, 280 F. Supp. 633 (D. Del. 1968); United States v. Blalock, 255 F. Supp. 268 (E.D. Pa. 1966). *See also* Note, 67 COLUM. L. REV., *supra* note 28.

30. *See, e.g.*, Schoepflin v. United States, 391 F.2d 390 (9th Cir.), *cert. denied*, 393 U.S. 865 (1968). *See also* Hotis, *Search of Motor Vehicles*, 73 DICK. L. REV. 363, 416 (1968); Mintz, *Search of Premises by Consent*, 73 DICK. L. REV. 44, 67 (1968).

Some courts, of course, continued to apply the voluntariness test; *e.g.*, State v. McCarty, 199 Kan. 116, 427 P.2d 616 (1967); State v. Forney, 181 Neb. 757, 150 N.W.2d 915 (1967).

31. 391 U.S. 543 (1968).

32. The warrant, however, was not used at trial for some unexplained reason, and the prosecution chose to rely on consent to justify the search. *Id.* at 546.

33. *See* Note, *Consent and the Constitution After Bumper v. North Carolina*, 6 CALIF. W.L. REV. 316 (1970).

sent was, in fact, freely and voluntarily given. This burden cannot be discharged by showing no more than acquiescence to a claim of lawful authority."[34] The force of this statement which apparently supported the voluntariness test, was unfortunately weakened when the Court added: "When a law enforcement officer claims authority to search a home under a warrant, he announces in effect that the occupant has no right to resist the search."[35] This statement has been construed as a recognition of the applicability of the waiver standard.[36]

Although *Bumper* seemed to embrace the voluntariness test of consent, the conflict continued among the courts. In *United States v. Mapp*[37] the Second Circuit cited *Bumper* for the proposition that "[w]here there is coercion there cannot be consent."[38] But the court went on to require proof of knowledgeable waiver in order to show an effective consent, citing *Johnson v. Zerbst.* The court held the search invalid because, applying the waiver principles, the consent was not " 'unequivocal, specific and intelligently given . . .' [amounting] to a knowing and voluntary waiver of constitutionally protected rights."[39]

Schneckloth presented the opportunity for the Court to clear up the waiver-voluntariness conflict.[40] Since it was apparent that neither test was compelled by precedent, the major question to be resolved was whether the voluntariness test or the waiver criteria better implements the policies of the fourth amendment. The Court did not discuss the policy considerations underlying the acceptance of voluntariness and rejection of the waiver standard beyond its general conclusion that waiver would impair the recognized utility of consent searches.[41]

One of the Court's arguments against application of the waiver standard in *Schneckloth* was based on its reluctance to require specific warnings of these rights before any consent search. Although there are conflicting opinions as to the necessary content of such warnings,[42]

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34. 391 U.S. at 548-49.

35. *Id.* at 550.

36. "Where the police claim authority to search yet in fact lack such authority, the subject does not know that he may permissibly refuse them entry, and it is this lack of knowledge that invalidates the consent." 412 U.S. at 285 (Marshall, J., dissenting and citing *Bumper*).

37. 476 F.2d 67 (2d Cir. 1973). This case was decided while *Schneckloth* was before the Supreme Court.

38. *Id.* at 77.

39. *Id.*

40. *See* text accompanying note 14 *supra.*

41. 412 U.S. at 227-31.

42. One author, after an in-depth analysis of the effects of *Miranda* on consent searches, has suggested that a warning should be required as follows:

the Court decided that any warning would destroy the utility of the consent search as a law enforcement device by upsetting the "informal and unstructured conditions" under which the ordinary request to search is made.[43]

Mr. Justice Marshall, in dissent, disagreed with the Court's conclusions as to the effect of a warning.[44] He argued that a decision to apply the knowing waiver standard to consent searches would not require that a warning requirement be judicially imposed on the police. Although the police would be assured of the admissibility of any evi-

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> You have a right to refuse to allow me to search your home, and if you decide to refuse, I will respect your refusal. If you do decide to let me search, you won't be able to change your mind later on, and during the search I'll be able to look in places and take things which I couldn't even if I could get a search warrant. You have a right to a lawyer before you decide, and if you can't afford a lawyer we will get you one and you won't have to pay for him. There are many different laws which are designed to protect you from my searching, but they are too complicated for me to explain or for you to understand, so if you think you would like to take advantage of this very important information, you will need a lawyer to help you before you tell me I can search.

Note, 67 COLUM. L. REV., *supra* note 28, at 158.

Others have been willing to settle for less detail; *e.g.*, "You do not have to consent to a search of your house, and without your permission, I cannot make any search without a search warrant." This statement was considered enough in Note, *Effective Consent to Search and Seizure*, 113 U. PA. L. REV. 260, 268 (1964). Mr. Justice Marshall appears to agree that this type of warning is all that is required in order to show that a person consents "knowingly." *See* note 44 *infra*.

MODEL CODE § SS 240.2(2) provides:

> **Required Warning to Persons Not in Custody or Under Arrest.** Before undertaking a search under the provisions of this Article, an officer present shall inform the individual whose consent is sought that he is under no obligation to give such consent and that anything found may be taken and used in evidence.

43. 412 U.S. at 232. The effects of a warning should be considered in the context of what groups of persons are likely to consent without the warning and who would not consent if warnings were given. One author lists five such groups: (1) innocent, cooperating citizens, (2) coerced consenters, (3) criminals attempting to curry favor, believing "the game is up," (4) citizens ignorant of right to refuse, and (5) guilty persons "attempting to outwit police and divert suspicion." Of these groups, he concludes that only two will be affected by warnings. The last group may even be encouraged to consent as a strategic ploy; while group four will be affected by warnings to the extent that "knowledge will merely serve to remove them into another class of consenters or refusers." Note, 67 COLUM. L. REV., *supra* note 28, at 159-60.

"Perhaps the strongest argument for requiring a warning is that without undue burden it will, in many cases, avoid confusion . . . . It is considerably less burdensome—both in terms of the difficulty of giving it and the number of times it will have to be given—than a warning prior to interrogation." MODEL CODE, *Commentary*, at 194.

44. "I doubt that a simple statement by an officer of an individual's right to refuse consent would do much to alter the informality of the exchange, except to alert the subject to a fact that he is surely entitled to know." 412 U.S. at 287.

It is significant that the F.B.I. and the Bureau of Narcotics and Dangerous Drugs have been giving warnings before obtaining consent "for decades" without apparent difficulty. MODEL CODE, *Commentary*, at 195.

dence seized, as a practical matter, only if a warning were given, he argued:

> It must be emphasized that the decision about informing the subject of his rights would lie with the officers seeking consent. If they believed that providing such information would impede their investigation, they might simply ask for consent, taking the risk that at some later date the prosecutor would be unable to prove that the subject knew of his rights or that some other basis for the search existed.[45]

It seems inevitable, however, that warnings would be necessary in most situations if the waiver standard were applied to consent searches.[46]

Furthermore, the Court pointed out that the waiver standard had been applied, "[a]lmost without exception . . . to those rights which the Constitution guarantees to a criminal defendant in order to preserve a fair trial."[47] It concluded that since the fourth amendment has "nothing whatever to do with promoting the fair ascertainment of truth at a criminal trial,"[48] the waiver approach would be misplaced in this context. This conclusion, however, does not withstand analysis.

There are two major policies to be considered in deciding which of the two standards to apply to any constitutional right. *First*, there is the policy of permitting "citizens to choose whether or not they wish to exercise their constitutional rights."[49] The waiver standard was formulated to promote this policy by requiring that a defendant be informed of his constitutional rights before he is allowed to forego them. *Second*, there is the policy of preventing *coercion* of a defendant in derogation of his constitutional rights. The voluntariness test is pri-

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45. 412 U.S. at 287. He concluded that the effect of the Court's opinion would be to relegate the protection of the fourth amendment to "the sophisticated, the knowledgeable, and . . . the few." *Id.* at 289.

46. "Unless the police undertake some responsibility for advising the person whose cooperation is sought of his rights, there are created the same problems of establishing that a consent to search is 'freely and voluntarily given,' as troubled the courts with confessions and led to the requirements imposed by *Miranda*." MODEL CODE, *Commentary*, at 193.

47. 412 U.S. at 237.

48. *Id.* at 242.

49. *Id.* at 283 (Marshall, J., dissenting). The Court in Miranda v. Arizona, 384 U.S. 436 (1966), implicitly recognized the importance of this policy. Although ostensibly based in terms of preventing coercion, *Miranda* recognized that the presence of counsel at interrogations, required under Escobedo v. Illinois, 378 U.S. 478 (1964), was sufficient to insure that a confession was "not the product of compulsion." 384 U.S. at 466. The warning requirement can be viewed as recognition that the policy of allowing an intelligent choice is equally as important as dispelling coercion.

marily concerned with promoting this policy but the waiver standard also prevents coercion where it interferes with exercise of free choice.[50] The difference in operation of the two standards can best be shown by a comparison of the policies of the fourth and fifth amendments.

Although these two amendments have long been recognized as overlapping and complementing each other,[51] there are distinctions; some are more subtle than their relative importance in ensuring a fair trial, which is the only one drawn by the Court.[52] There are no circumstances under which self incrimination can constitutionally be compelled. The concern of the fifth amendment, then, is with *compulsion.* Logically the voluntariness test was developed in this context to promote the second policy above. But even in this area of concern with coercion, the voluntariness test proved unsatisfactory and was discarded in *Miranda.* The waiver standard with its concommitant warnings was substituted, but still with the primary function of preventing the coercion inherent in all custodial interrogations.[53] The first policy is not applicable to a great extent to the fifth amendment since "no sane person would knowingly relinquish a right to be free of compulsion."[54]

The fourth amendment right to privacy, on the other hand, can forcibly be invaded whenever the police have probable cause and a warrant. Since the ordinary consent search takes place in the defendant's familiar surroundings rather than the inherently coercive atmosphere of police custody, the coercion problem is less prominent.[55]

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50. "[I]t is just as unconstitutional to search after coercing consent as it is to search after uninformed consent . . . ." 412 U.S. at 282 n.8 (dissenting opinion).

51. *See, e.g.,* Mapp v. Ohio, 367 U.S. 643 (1961); Boyd v. United States, 116 U.S. 616 (1886).

52. *See* text accompanying note 47 *supra.*

53. *Miranda* recognized the importance of the waiver criteria in promoting intelligent choice; *see* note 49 *supra.* But the Court's primary concern in *Miranda* was with *coerced* confessions, and the waiver criteria implicit in the warnings related to the waiver of those rights of which a suspect is informed; not to the waiver of the right to be free of compulsion.

54. 412 U.S. at 281 (dissenting opinion).

55. The Court, in *Schneckloth,* specifically left open the question whether the waiver standard and warnings are required if consent is obtained from a suspect in custody. It noted, however, "that other courts have been particularly sensitive to the heightened possibilities for coercion when the 'consent' to a search was given by a person in custody." *Id.* at 240-41 n.29.

The lower courts have disagreed on the validity of in-custody consent. *Compare* People v. Garcia, 227 Cal. App. 2d 345, 38 Cal. Rptr. 670, *cert. denied,* 379 U.S. 949 (1964), *and* People v. Valdez, 188 Cal. App. 2d 750, 10 Cal. Rptr. 664 (1961), *and* State v. Forney, 181 Neb. 757, 150 N.W.2d 915 (1967), *with* Channel v. United States, 285 F.2d 217 (9th Cir. 1960), *and* Judd v. United States, 190 F.2d 649 (D.C. Cir. 1951), *and* State v. Witherspoon, 460 S.W.2d 281 (Mo. 1970).

Although the Court points out that a defendant's ignorance of his fourth amendment rights is one of the factors to be considered under the voluntariness test,[56] it is a weak concession to the first policy above when the coercion question is the ultimate inquiry.[57] Since the knowledge factor is not conclusive of "coercion," it is difficult to conceive of how a defendant who has no knowledge of his fourth amendment rights and yet who is not coerced under the test, can be said to have *chosen* to forego those rights by consenting to a search. Therefore, the voluntariness test, rejected even in the fifth amendment context where coercion is the main problem, is surely an ill-fitting transplant into the fourth amendment.

The Court argued, however, that it is not the policy of the fourth amendment "to discourage citizens from aiding to the utmost of their ability in the apprehension of criminals."[58] Obviously the encouragement of citizen cooperation, however, cannot override concern for the protection of constitutional rights. Police convenience in conducting searches where there is both insufficient evidence to constitute probable cause for a warrant and no exigent circumstances which allow the warrant to be dispensed with, is an important consideration, but it must not be allowed to deprive citizens of the right to *choose* whether to cooperate or to assert their constitutional rights.

As support for its position that consent is not a waiver in the constitutional sense, the Court argued that the waiver standard is inconsistent with those cases upholding searches based upon the consent of a third party.[59] However, it seems questionable that the recognized validity of third party consent is inconsistent with application of a waiver standard to a defendant's consent. Such searches are upheld on the rationale that by entrusting his property so completely to a third party, the defendant no longer has a justifiable expectation of privacy in the property and that he "assumes the risk" that the third

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The Model Code provides that any in-custody consent is invalid unless *Miranda* warnings and fourth amendment warnings were given. MODEL CODE § SS 240.2(3).

56. 412 U.S. at 249.

57. The policy of allowing an intelligent choice seems particularly applicable to the fourth amendment if it is assumed that an individual is more likely instinctively to protect the privacy of his *thoughts* without knowledge of his fifth amendment rights to such privacy, than he is to protect the privacy of his *possessions* without knowledge of protection under the fourth amendment.

58. 412 U.S. at 243, *quoting* Coolidge v. New Hampshire, 403 U.S. 443, 488 (1971).

59. "[I]t is inconceivable that the Constitution could countenance the waiver of a defendant's right to counsel by a third party, or that a waiver could be found because a trial judge reasonably, though mistakenly, believed a defendant had waived his right to plead not guilty." 412 U.S. at 246.

party will allow a search.[60] Therefore, the defendant cannot assert the fourth amendment to bar admission of evidence seized in the search, not because his rights were waived by the third party, but because he has relinquished his privacy.[61] The question whether the waiver standard applies to the consent of the third party as a relinquishment of *his own* right to privacy in the property over which he had control remained unresolved in those cases.[62]

It is clear from the foregoing analysis that the voluntariness test for determining the validity of a consent to search is neither required by precedent nor well suited to the policies of the fourth amendment. Even so, the practical effects of the Court's decision may not be felt immediately. However, the use of the consent search device to overcome the warrant and probable cause requirements of the fourth amendment is likely to increase. With voluntariness as the test to be used for challenged searches, it is not difficult to predict that, in many cases, unsophisticated defendants will be held to have "waived" constitutional rights, the existence of which they had no knowledge.

WILLIAM R. SAGE

Environmental Law—Rucker v. Willis: Are Impact Statements for Private Projects That Require Federal Permits an Endangered Species?

The National Environmental Policy Act of 1969 (NEPA)[1] has had a short yet tumultuous history. In declaring a national policy concern-

60. *See* Frazier v. Cupp, 394 U.S. 731 (1969). This rationale is logical when read in conjunction with the "right to privacy" approach to the fourth amendment in Katz v. United States, 389 U.S. 347 (1967).

61. This approach is consistent with the "misplaced trust" cases in which a defendant is unprotected by the fourth amendment in his disclosures to a trusted third party who turns out to be a police informant and who either reports to the police or simultaneously records or transmits his conversations with the defendant. *See, e.g.*, United States v. White, 401 U.S. 745 (1971); Hoffa v. United States, 385 U.S. 293 (1966).

62. The Supreme Court has not been consistent in its justification of third party consents. It initially accepted the rationale that the defendant had made the third party his agent with "apparent authority" to waive his right to privacy. *See* Stoner v. California, 376 U.S. 483 (1964). This "agency" rationale has been thoroughly criticized; *see* Note, 67 COLUM. L. REV., *supra* note 28, at 48-50; Note, 113 U. PA. L. REV., *supra* note 42, at 272-77. *See generally* Hotis, *supra* note 30, at 417-20; Mintz, *supra* note 30, at 49-50; Scurlock, *Basic Principles of the Administration of Criminal Justice with Particular Reference to Missouri Law*, 38 U.M.K.C.L. REV. 167, 205-06 (1970).

1. 42 U.S.C. §§ 4321-47 (1970).

ing the environment[2] and in establishing certain procedural requirements for federal agencies to follow to insure that their activities are environmentally advisable,[3] NEPA was expected to have a profound effect on all "major Federal actions significantly affecting the quality of the human environment."[4] NEPA has lived up to its expectations,[5] involving the judiciary in the storm created by its mandates.[6] Caught in the midst of NEPA litigation have been the federal agencies on whose shoulders the brunt of the NEPA burden has fallen. The "new and unusual"[7] instruction to the agencies—to consider the environmental consequences of their activities "to the fullest extent possible"[8]—is an attempt to broaden their jurisdictional responsibility,[9] to prod them to internalize environmental considerations, and to force them to expose their crucial environmental decisions to public scrutiny. Now that agencies have the statutory obligation to consider fully the environmental effects of their actions and to "utilize a systematic, interdisciplinary approach"[10] in planning their activities, some commentators have

2. NEPA § 101, 42 U.S.C. § 4331 (1970).

3. NEPA § 102, 42 U.S.C. § 4332 (1970). The now familiar "impact statement" mandated by NEPA is its most far-reaching procedural requirement. NEPA also created, in the Executive Office of the President, a multi-purpose Council on Environmental Quality (CEQ). NEPA § 202, 42 U.S.C. §§ 4342-46 (1970).

4. NEPA § 102(2)(C), 42 U.S.C. § 4332(2)(C) (1970).

5. Over 3,000 environmental impact statements had been filed with the Council on Environmental Quality as of May 30, 1972. Cohen, *The Anatomy of Environmental Impact Statements*, 10 LAND & NAT. RESOURCES L.J. 271 (July 1972). It has been reported that new environmental impact statements "are being received [by CEQ] at the rate of about five per day." Cramton & Berg, *On Leading a Horse to Water: NEPA and the Federal Bureaucracy*, 71 MICH. L. REV. 511, 514 (1973), *citing* 1972 ANN. REP. OF THE COUNCIL ON ENVIRONMENTAL QUALITY 247.

6. "As of Dec. 1, 1972, there have been at least 140 reported federal court decisions dealing with NEPA challenges to federal projects." Brown, *NEPA Litigation to Date*, in 1 A. REITZE, ENVIRONMENTAL LAW 3 (Supp. 1973).

7. City of New York v. United States, 337 F. Supp. 150, 164 (E.D.N.Y. 1972). "NEPA is a new and unusual statute imposing substantive duties which overlie those imposed on an agency by the statute or statutes for which it has jurisdictional responsibility. Initially harmonizing and integrating the special duties imposed by NEPA with an agency's traditional regulatory functions is not an easy task." *Id.* *See also* Hanly v. Mitchell, 460 F.2d 640, 644 (2d Cir. 1972).

8. NEPA § 102, 42 U.S.C. § 4332 (1970).

9. Justice Douglas in his dissent to the denial of certiorari in Scenic Hudson Preservation Conference v. FPC, 407 U.S. 926, 927 (1972), stated that the NEPA "mandate was aimed partly at eliminating the excuse which had often been offered by bureaucrats that their statutory authority did not authorize consideration of such factors [as environmental consequences] in their policy decisions." That NEPA has been effective for Douglas' purpose is indicated by a comment of Harold L. Price, AEC Director of Regulations, that "We [the AEC] now have to go back and study things like water quality where we didn't even think we had jurisdiction." 1 A. REITZE, *supra* note 6, at one-42.

10. NEPA § 102(2)(A), 42 U.S.C. § 4332(2)(A) (1970).

found "a dramatic change in the perspectives of a number of federal agencies."[11] Others, however, have noted that agencies are "reluctantly seeking to comply with the letter, but not the spirit of NEPA."[12]

Agencies have used several defenses in an attempt to avoid NEPA's obligations.[13] One of these defenses is the contention that a particular project does not involve a "major Federal action significantly affecting the quality of the human environment,"[14] and thus the "action forcing"[15] command of NEPA's section 102(2)(C) impact statement does not apply. This note will examine this agency defense against NEPA's application, especially as it relates to the recent case of *Rucker v. Willis*.[16]

THE FACTS OF RUCKER V. WILLIS

Defendant Edward Willis owned a tract of land on Bogue Bank[17] near the town limits of Emerald Isle, North Carolina. The property

11. Cramton & Berg, *supra* note 5, at 512. The authors further report that "insiders conversant with the Washington scene agree that the AEC and the Army Corps of Engineers have undergone a dramatic transformation since enactment of NEPA. Significant changes in the manner and substance of decision-making in the Departments of Defense, Interior, and Transportation have also been noted." *Id.* at 512 n.4. It has also been argued, however, that "it is fatuous to expect that administrators can do any more than get a little outside of their normal perspectives." 3 ENVIR. REP. 1434 (March 30, 1973).

12. Note, *Environmental Law—Substantive Judicial Review Under The National Environmental Policy Act of 1969*, 51 N.C.L. REV. 145, 146 (1972). Cramton & Berg, *supra* note 5, at 512, also address this concern: "[T]here is danger that the spirit [of NEPA] will be undermined—in some agencies—by mere observance of form that fails to grapple with the underlying realities." Another commentator has noted the tendency of some agencies to move "with less than deliberate speed" in fulfilling NEPA's obligations. 3 ENVIR. REP. 1434 (March 30, 1973).

13. Brown, *supra* note 6, gives three categories of cases that have arisen because of defenses used by federal agencies to justify their decision not to prepare an environmental impact statement. The first category addresses the issue of NEPA's retroactivity, *i.e.*, whether NEPA's mandates attach to projects begun before 1970. The second group deals with the agency contention that the agency is exempt from NEPA's mandate. The third category addresses the agency contention, investigated by this note, that its action under review is not a major federal action or that it does not significantly affect the environment. The most predominant question litigated under NEPA has not been agency defenses but has involved the adequacy of an impact statement once it is prepared. Brown uses these four broad categories to categorize very effectively all the cases under NEPA.

14. NEPA § 102(2)(C), 42 U.S.C. § 4332(2)(C) (1970).

15. The term "action forcing" was a characterization of Sen. Henry Jackson. *See Hearings on S. 1075, S. 237, and S. 1752 Before the Senate Comm. on Interior and Insular Affairs*, 91st Cong., 1st Sess. 206 (1969). *See also* Calvert Cliffs' Coordinating Comm., Inc. v. AEC, 449 F.2d 1109, 1113 (D.C. Cir. 1971). As Judge Friendly states in his dissent in Hanly v. Kleindienst, 471 F.2d 823, 837 (2d Cir. 1972), "Most of its [NEPA's] provisions are hortatory; the only one with teeth is the [impact statement] mandate in subdivision (2)(C) . . . ."

16. 358 F. Supp. 425 (E.D.N.C.), *aff'd*, 484 F.2d 158 (4th Cir. 1973).

17. Bogue Bank is a narrow island off the North Carolina coast. The Bank lies

stretched across the narrowest part of Bogue Bank where the distance between the Atlantic Ocean and Bogue Sound is less than six hundred feet. Defendant Willis and defendant Twin Piers, Inc. agreed to develop this property by constructing a 1,150 foot pier into the Atlantic Ocean and a pier and marina extending four hundred feet into Bogue Sound. The marina required that a boat basin and access channel be dredged in Bogue Sound. Between the marina and the pier a paved parking lot would be constructed that would occupy practically the entire width of the Bank.

On December 2, 1972, Willis filed with defendant Wilmington District Corps of Engineers a request for a permit[18] authorizing construction of the piers and dredging operations. Public notice of Willis' application was given on January 4, 1973, by the Corps.[19] The notice indicated that written comments pertinent to the proposed work would be received in the Corps' Wilmington office until February 5, 1973, and copies were mailed to approximately one hundred seventy-five governmental agencies, environmental groups, corporations, and individuals. After receipt of all the comments in response to the public notice, and after a three month period of "study and consideration,"[20] the Corps determined that the proposed development was not a "major Federal action significantly affecting the quality of the human environment,"[21] and that therefore no environmental impact statement was required. No written findings were made by the Corps itself, and no record of the Corps' own independent analysis of the application was released, if such an analysis were ever compiled. The Corps simply issued the permit on April 9, 1973, without comment. Construction on the project began immediately, and by April 20, 1973, the defendants had completely

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directly to the east of the seaside town of Morehead City, and is separated from the mainland by Bogue Sound.

18. The request was made pursuant to the Rivers and Harbors Appropriation Act of 1899, 33 U.S.C. § 403 (1970). The Act requires a permit to create any "obstruction" to the "navigable capacity of any of the waters of the United States . . . ."

19. The public notice described the project briefly and then stated:

> The decision as to whether a permit will be issued will be based on an evaluation of the impact of the proposed work on the public interest. Factors affecting the public interest include, but are not limited to, navigation, fish and wildlife, water quality, economics, conservation, aesthetics, recreation, water supply, flood damage prevention, ecosystems, and in general, the needs and welfare of the people. Comments on these factors will be accepted and made part of the record and will be considered in determining whether it would be in the best public interest to grant a permit.

20. The terminology is that of the Fourth Circuit. 484 F.2d at 161. The degree of "study and consideration" is not specified.

21. *See* NEPA § 102(2)(C), 42 U.S.C. § 4332(2)(C) (1970).

"leveled the sand dunes"[22] between the ocean and the sound. Dredging and construction began soon afterwards.

On April 19, 1973, adjoining landowners filed an action seeking injunctive relief against the project. The next day motions for a temporary restraining order and preliminary injunction were heard by the district court. The court denied these motions, finding that the Corps of Engineers "followed a systematic procedure and reached a reasonable decision" in not requiring an environmental impact statement.[23] The court further found that the issuance of the permit to the defendants' project was not a "major Federal action."[24] The plaintiffs appealed, and the Fourth Circuit affirmed the district court decision.[25]

The backbone of the district and circuit court opinions in *Rucker* was the holding that the grant of the Corps' permit did not constitute a "major Federal action significantly affecting the quality of the human

22. 358 F. Supp. at 426.

23. *Id.* at 430.

24. *Id.* The decision of the court of appeals and district courts that the Willis project was not a "major federal action" does not lend itself to lengthy analysis. The "major federal action" question can be discussed independently of the "significantly affecting" phrase due to the "dual test" used by the Fourth Circuit. *See* note 54 *infra.* Two points on the "major federal action" issue are significant in *Rucker.*

(1) The permit-project distinction. The district court took notice of the fact that there were not federal funds involved in the project but merely a federal review for permit purposes, and held that "reviewing only . . . does not constitute 'major federal action' as contemplated by NEPA." 358 F. Supp. at 430. This view runs directly contrary to the CEQ guidelines which provide that federal " 'actions' include . . . (ii) Projects and continuing activities . . . involving a federal lease, permit, license, certificate, or other entitlement for use." 36 Fed. Reg. 7724-29 (1971), *see* note 33 *infra.* The district court holding also runs contrary to the Corps' own regulations which contain guidelines and procedures to be followed when "Regulatory Permits" are involved in projects that "would have a significant and adverse effect" on environmental quality. 37 Fed. Reg. 2526 (1972); *see* note 65 *infra.*

The Fourth Circuit apparently corrected the district court's implication that NEPA applied only to projects and not permits. The court of appeals stated: "Although issuing a permit for such a pier is undoubtedly federal action, whether it is major federal action . . . [is a] factual matter" to be determined by the district judge. 484 F.2d at 163.

(2) The jurisdiction question. There is a latent dispute about the scope of the Corps' jurisdiction in evaluating the Willis project. The district court found a large percentage of the project "above mean-high water line," and declared correctly that federal jurisdiction only extended to the mean-high mark. The Corps' public notice, however, places no such limitation on the scope of the Corps' inquiry when the Corps seeks to evaluate the environmental effects of a project for permit purposes. *See* note 19 *supra. See also* Zabel v. Tabb, 430 F.2d 199 (5th Cir. 1970), *cert. denied,* 401 U.S. 410 (1971) (ecology of area taken into account); Citizens for Clean Air, Inc. v. Army Corps of Engineers, 349 F. Supp. 696, 700-01 ("total impact" to be considered); 33 C.F.R. §§ 209.120(d)(1), (3) (1973) (Corps regulations: effect on conservation, pollution, aesthetics, ecology, and adjacent shore properties is to be considered).

25. Rucker v. Willis, 484 F.2d 158 (4th Cir. 1973). Judge Widener was joined by Chief Judge Haynsworth, with Circuit Judge Craven dissenting.

environment."[26] Considerable conflict over the meaning of this NEPA phrase has been created by attempts to interpret what has been characterized as NEPA's "opaque" and "woefully ambiguous"[27] language. Implicit in these attempts have been efforts to balance competing interests. On the one hand, is the need to avoid the application of NEPA to agency actions that are "too trivial, too routine, or too remote in consequences to merit an impact statement."[28] On the other hand, is the realization by the courts that if they determine that an agency action does not fall within the NEPA phrase, NEPA will not be activated at all, and all of its procedural and substantive safeguards will be avoided. From this perspective, some have realized that if no major and significant federal action is found, NEPA's effectiveness would be negated "in the most fundamental way" in that "low level federal activities would be exempted"[29] from the statute's mandates. For these reasons "the courts have policed the lower boundaries of NEPA's application with greater than ordinary vigilance and have worked in concert with the CEQ [Council of Environmental Quality] guideline-setting process to keep the threshold low."[30]

THE SCOPE OF AN AGENCY'S DISCRETION IN MAKING A THRESHOLD IMPACT STATEMENT DETERMINATION

There have been scattered judicial attempts to clarify NEPA's statutory language,[31] even in the face of an early admonition that NEPA's

26. For a comprehensive collection of other cases decided on a basis similar to Rucker, see F. ANDERSON, NEPA IN THE COURTS: A LEGAL ANALYSIS OF THE NATIONAL ENVIRONMENTAL POLICY ACT 77-79 & nn.90-99 (1973) [hereinafter cited as NEPA IN THE COURTS].

27. *See* Hanly v. Kleindienst, 471 F.2d 823, 825 (2d Cir. 1972), *citing* City of New York v. United States, 337 F. Supp. 150, 159 (E.D.N.Y. 1972); Voigt, *The National Environmental Policy Act and the Independent Regulatory Agency*, 5 NATURAL RESOURCES LAW. 13 (1972).

28. NEPA IN THE COURTS 82.

29. *Id.* at 74.

30. *Id.* at 74-75.

31. *See* Hanly v. Kleindienst, 471 F.2d 823, 830-31 (2d Cir. 1972) (attempting to clarify "significantly affecting"); Hanly v. Mitchell, 460 F.2d 640, 644 (2d Cir. 1972) (commenting on meaning of "major federal action"); Natural Resources Defense Council, Inc. v. Grant, 341 F. Supp. 356, 366-67 (E.D.N.C. 1972) (defining both phrases). The court of appeals in *Rucker* noted four definitional indicia which might also be used to measure if a permit is a "major federal action." These involved (1) the use of federal funds, (2) federal designing or planning involvement, (3) projects carried out "under the auspices of a federal agency," and (4) the qualitative impact on the environment. The court found none of these indicia to be present in *Rucker*. 484 F.2d at 163. The court held that "the record now indicates" that the Willis project would not significantly affect the environment. *Id.* Contrary readings of the record are possible, as shown by Judge Craven's dissent. *See* note 54 *infra* as to (4) above.

language is "extremely broad and not susceptible of precise definition."[32] More frequent than efforts to define specifically the "major federal action" and the "significantly affecting" phrases, however, have been attempts on a case-by-case basis to refine and determine the essence of NEPA's mandate in this area. Many cases have placed emphasis on the CEQ guidelines.[33] The most productive effort, however, has occurred in several judicial attempts to define the scope of an agency's autonomy in making the threshold determination of whether an impact statement is necessary.[34]

In *S.C.R.A.P. v. United States*,[35] the plaintiffs sought to enjoin an Interstate Commerce Commission (ICC) order allowing railroads temporarily to add a 2.5 percent surcharge to the normal rate charged for freight. S.C.R.A.P. charged that the freight increase constituted a major federal action significantly affecting the environment since the shipping increase boosted the cost of shipping recyclable materials and aggravated the preexisting disparity in shipping costs between these materials and the primary goods with which they compete.[36] The ICC dismissed the attacks on its actions in one terse sentence: "[T]he involved general increase will have no significant adverse effect on . . . the quality of the human environment within the meaning . . ." of NEPA.[37] Judge J. Skelly Wright responded to the ICC's actions:

> It should be obvious that the NEPA requirement cannot be circumvented by so transparent a ruse. The main purpose of an impact statement is to force assessment of the environmental im-

32. Citizens for Reid State Park v. Laird, 336 F. Supp. 783, 789 (D. Me. 1972).

33. 36 Fed. Reg. 7724-29 (1971). The importance of the CEQ guidelines will become evident *infra*. For a common perspective on the CEQ guidelines, see Students Challenging Regulatory Agency Procedures (S.C.R.A.P.) v. United States, 346 F. Supp. 189, 200 n.14 (D.D.C. 1972), which notes that "[a]lthough the CEQ guidelines lack the force of law, we should 'not lightly suggest that the Council, entrusted with the responsibility of developing and recommending national policies "to foster and promote the improvement of the environmental quality," . . . has misconstrued NEPA.'" The CEQ has recently proposed certain amendments to their guidelines. 38 Fed. Reg. 10856 (1973).

34. No courts challenge the agency's power to make the threshold determination —as to that power, NEPA is clear. *See* Citizens for Clean Air, Inc. v. Army Corps of Engineers, 349 F. Supp. 696, 706-07 (S.D.N.Y. 1972), *citing* Hanly v. Mitchell, 460 F.2d 640 (2d Cir. 1972); Citizens for Reid State Park v. Laird, 336 F. Supp. 783, 789 (D. Me. 1972) ("The Act plainly commits this preliminary determination to the agency."). When the agencies' threshold decision is challenged, then the court's role begins. Natural Resources Defense Council, Inc. v. Grant, 341 F. Supp. 365, 366 (E.D.N.C. 1972); Scherr v. Volpe, 363 F. Supp. 886, 888 (W.D. Wis. 1971).

35. 346 F. Supp. 189 (D.D.C. 1972), *rev'd*, 93 S. Ct. 2405 (1973).

36. 346 F. Supp. at 191.

37. *Id.* at 200. *See also id.* at 200 n.16.

> pact of a proposed action. Therefore, a statement is required whenever the action *arguably* will have an adverse impact.[38]

Soon after *S.C.R.A.P.*, the Second Circuit in *Hanly v. Mitchell*[39] was given the opportunity to pass on the sufficiency of a General Service Administration (GSA) determination that an impact statement was not needed prior to the construction of a detention center in an area of lower Manhattan. The court in *Hanly I* determined that the "peculiar" environmental impact of the jail project was not sufficiently detailed in the short GSA "Environmental Statement." The GSA then compiled a twenty-five page "Assessment" of the environmental impact of the proposed jail. The district court found the assessment to be adequate, but the Second Circuit in *Hanly II* again reversed.[40] The decision in *Hanly II* is presently the most refined—and demanding—inquiry into the adequacy of an agency's threshold impact statement determination.

There were two bases for the reversal in *Hanly II*—the substantive inadequacy of the assessment itself in considering the environmental effects of the jail, and the procedural inadequacy of the GSA's administrative process in determining those effects. Two elements caused the court's finding of substantive inadequacy. The first element was the assessment's failure to deal conclusively with the possibility of a drug maintenance program at the detention center, which the appellant's charged would increase the risk of crime in the area. The second element was an affidavit received by the district court that challenged certain findings of fact in the assessment.[41] The *Hanly II* court found that these two factors conclusively established the assessment's substantive inadequacy. This holding represents an unquestionably strict review of any agency's threshold determination that an impact statement is unnecessary. The appellant's presentation of two factual issues that went unanswered by the assessment was sufficient to

38. *Id.* at 201 (emphasis in original). The Supreme Court's subsequent reversal of the district court in *S.C.R.A.P.* left intact the essence of Judge Wright's impact statement requirements. The Court did find, however, that NEPA did not limit the ability of the ICC to set rates, for rate setting was found to be an exclusive ICC function due to the Interstate Commerce Act. Thus, the basis of the reversal was primarily jurisdictional, and did not reach the question of the adequacy of the ICC's threshold impact statement process. "We need not reach the issue whether the District Court was justified in issuing a preliminary injunction, because we have concluded that the court lacked jurisdiction to enter an injunction in any event." S.C.R.A.P. v. United States, 93 S. Ct. 2405, 2417 (1973).

39. Hanly v. Mitchell, 460 F.2d 640 (2d Cir.), *cert. denied*, 409 U.S. 990 (1972) (Hanly I).

40. Hanly v. Kleindienst, 471 F.2d 823 (2d Cir. 1972), *cert. denied*, 93 S. Ct. 2290 (1973).

41. *See* 471 F.2d at 834-36.

convince the court of the incompleteness of the study. In this light, one must broadly construe the *Hanly II* observation that "an agency, in making a threshold determination as to the 'significance' of an action, is called upon to review in a general fashion the same factors that would be studied in depth for preparation of a detailed environmental impact statement . . . ."[42] *Hanly II* seems to require that all disputed factual issues and asserted concerns presented by a plaintiff must be at least generally responded to in a threshold statement. This conclusion is consistent with the *Hanly I* finding that "the essential point is that GSA [the agency] must actually consider [the plaintiff's concerns]."[43]

The procedural grounds for the decision in *Hanly II* are also significant. The court made the finding that the procedural mandates of sections 102(2)(A), (B), and (D) of NEPA[44] apply not only to actions which the agency finds to be significant, but also to actions under review even at the threshold impact statement level.[45] The court then determined that section 102(2)(A) and (D) had been met by the assessment, but that (B) had not.[46] Holding that section 102(2)(B) required that "some rudimentary procedures be designed to assure a fair and informed preliminary decision,"[47] the court expanded *Hanly I's* mandate that federal agencies must "affirmatively develop a reviewable environmental record . . . even for purposes of a threshold section 102(2)(C) determination."[48] The expansion was achieved by requiring that public notice of the proposed federal action be given by the agency before a determination of "significance" is made, and by suggesting that provision for public hearings on the action may in some instances be advisable.[49]

The stringent procedural and substantive standards established in *Hanly II* may attract substantial adherents. The tone and strictness of *Hanly II* are already matched by the language of *Citizens for Clean Air, Inc. v. Army Corps of Engineers*,[50] which, like *Rucker*, involved the granting of a Corps' dredge and fill permit. At issue was the possible air pollution caused by Consolidated Edison's construction of an elec-

42. *Id.* at 835.
43. 460 F.2d at 648.
44. 42 U.S.C. §§ 4332(2)(A), (B), (D) (1970).
45. 471 F.2d at 834-35.
46. *Id.*
47. *Id.* at 835.
48. 460 F.2d at 647.
49. *See* note 59 *infra*, as to how these procedural holdings apply to *Rucker*.
50. 349 F. Supp. 696 (S.D.N.Y. 1972).

trical generating plant in New York City. The Corps granted the permit without filing an impact statement.[51] The district court responded:

> Without making its own analysis of the impact of the construction, it [the Corps] merely cited the fact that state permits were given and the Department of the Interior did not object, and the EPA "offered no objection . . . ." [T]his perfunctory listing of other agencies' conclusions is an inadequate record to support the Corps' threshold determination, and legally constitutes arbitrary and capricious action . . . .[52]
>
> The fact that no one explicitly attacked two environmental features of the project . . . *alone* cannot serve as a basis *alone* for the Army Corps' finding that there would be no significant impact on the environment . . . . Negative evidence of environmental impact . . . cannot be substituted for the Corps' affirmative determination, independently made, that the impact is insignificant.[53]

The court held that the permit previously issued was void.

THREE DEFECTS IN RUCKER V. WILLIS

Judged against this background,[54] the decision in *Rucker* is subject to three defects that cast doubt on its correctness.

a. The Scope of the Agency Discretion Permitted by Rucker. One defect in *Rucker* involves the burden an agency must sustain to support its threshold determination that an impact statement is not necessary. This issue is crucial in *Rucker* for several reasons. First, the Corps "is-

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51. The similarities between *Rucker* and *Citizens* are clear. One point of distinction between the cases, however, was that in *Citizens* the factor of major federal action was conceded by the Corps; the same concession was also made in the *Hanly* dispute.

52. 349 F. Supp. at 707. This quote was preceded by the finding that "The Corps has the duty of making clear its threshold decision, the rationale for the decision, and the means of arriving at that determination . . . ." *Id.* This is exactly what was lacking in *Rucker*.

53. *Id.* at 707 n.18 (emphasis in original).

54. Within the NEPA phrase, the "major federal action" question can be discussed independently of the "significantly affecting the . . . environment" phrase due to the dual test used by the Fourth Circuit. *See* Natural Resources Defense Council v. Grant, 341 F. Supp. 356, 366-67 (E.D.N.C. 1972). *See also* the Second Circuit's statement in *Hanly I*, "We agree . . . that the two concepts are different . . . ." 460 F.2d at 644. There is apparently some overlap in the tests even in the Fourth Circuit, however; by using the "qualitative impact" on the environment as an indicia for determining major federal action, note 31 *supra*, the *Rucker* court implicitly holds that if the environmental effect of any project is significant, it will always be a major federal action, regardless of the project's size. This coincides with the conclusion that "[w]hile the cases favor a two-test standard, they have never held that the small size of a federal project will exempt it from NEPA if its environmental effects are significant." NEPA IN THE COURTS 74. A more complete review of the dual test as opposed to the one test standard is beyond the scope of this note.

sued no written findings. Neither did it specifically state that an impact statement was not necessary."[55] This defect is by no means fatal,[56] yet the failure to file any written findings raises the precise objections that were voiced by the courts in *Hanly I* and *II* and *Citizens for Clean Air* involving the insufficiency of the agencies' investigation in support of its threshold impact statement determination.

The absence of written findings takes on added significance in *Rucker* because the Corps' decision not to prepare an impact statement "was based on the fact that no Federal, State, or local agencies certified to [it] that the permit would have a significant and adverse effect on the human environment."[57] Despite the fact that the Corps is the lead agency on the project and must comply with NEPA "to the fullest extent possible," the agency relied not on its own independent examination[58] but on the absence of certification by others. Aside from the fact that this places the agency with primary responsibility for federal action in deference to other agencies and groups who were merely asked for comments on an application for a permit, it also appears that the Corps was subtly delegating what should be its overall responsibility to other agencies. The court in *Citizens for Clean Air* unequivocally rejected this procedure: "[T]his perfunctory listing of other agencies' conclusions is an inadequate record to support the Corps' threshold determination . . . ."[59]

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55. Rucker v. Willis, 484 F.2d 158, 159 n.2 (4th Cir. 1973). The court continues: "From the issuance of the permit, however, the necessary inference is a finding that no impact statement was necessary, since the statute, 42 U.S.C. § 4332(2)(C), and the applicable regulation, 37 Fed. Reg. 2525 (Feb. 2, 1972), para. 11(c), both require a statement if their conditions are met, but do not require a negative finding or statement." *Id.* The court's reading of the regulations is rather dated and selective, as argued by Judge Craven's dissent. The Corps' new guidelines require written findings setting forth the reasons for not preparing an impact statement. Reg. No. 1105-2-507, §§ 4(b)(2), 5(g)(2). 38 Fed. Reg. 9243-44 (1973). However, the effectiveness of these new guidelines is put into question by the *Rucker* decision. Even if the new regulations do effectively end the tactics the Corps used in *Rucker*, the issue is still alive for most other federal agencies affected by NEPA.

56. *See* Citizens to Preserve Overton Park, Inc. v. Volpe, 401 U.S. 402, 409 (1971), where the Court states that "formal findings were not required." Judge Craven notes in his dissent the extenuating circumstances in *Overton Park*, and concludes that the new Corps' regulations should be applied to *Rucker*. 484 F.2d at 164.

57. 358 F. Supp. at 429.

58. Such an independent examination was required in *Hanly I* and *II*, *supra* notes 39-49, and *Citizens for Clean Air*, *supra* notes 50-53.

59. 349 F. Supp. at 707. In concluding this discussion of the procedural aspects of *Rucker*, it is helpful to compare the procedure of *Rucker* to the procedural mandate given in *Hanly II*, *supra* notes 47-49. Since the public notice was given in *Rucker* the first procedural complaint of *Hanly II* was satisfied. However, the second procedural suggestion (but not requirement) of *Hanly II*, the use of a public hearing, is especially intriguing when applied to *Rucker*. *Hanly II* noted that the public hearing was

Although the Corps merely relied on the lack of adverse comments[60] to determine that no impact statement was necessary, they convinced the *Rucker* court that the agency had made a "wide-ranging, good-faith assessment . . . of the potential environmental impact of the proposed project."[61] At no point, however, is there evidence that the Corps or any other agency addressed many of the substantial adverse effects which the plaintiffs alleged.[62] The manner in which the Corps did deal with problems they characterized as "essentially matters of local zoning" was similarly superficial.[63] It is obvious that the Corps' threshold procedure did not, as *Hanly I* and *II* required, cover generally all the substantive areas that a full impact statement would more specifically describe. The *Rucker* procedure, which required no written findings by the Corps itself, did not allow the plaintiffs an opportunity to determine if the Corps had even considered many of their substantive concerns.

b. The CEQ "Cumulative Impact" Guideline. The second major defect of the *Rucker* decision involves the court's failure to respond ade-

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a "procedure usually followed in zoning disputes." 471 F.2d at 835. It was noted in *Rucker* that most of the complaints against the pier and marina were "essentially matters of local zoning." *See* note 63 *infra*. It thus appears that *Rucker* provided the perfect procedural setting in which to use the *Hanly II* public hearing suggestion. The Corps' own regulations provide for public hearings, 33 C.F.R. § 209.120(g) (1972), so the idea is by no means unusual.

60. The Corps did receive quite a few adverse comments—one of which was a petition signed by 70 landowners. The United States Department of the Interior, Fish and Wildlife Service commented by recommending that the permit should be denied unless their modifications were incorporated into the permit. One of these modifications was that dredging be limited to 5 feet—due to a turbidity problem—for the boat basin. The district court noted that the Department of the Interior proposal was made a part of the permit. Yet, the permit actually issued allows dredging to 7 feet for the boat basin. The discrepancy is unexplained in the record. 358 F. Supp. at 429.

61. 484 F.2d at 162.

62. The following adverse effects were alleged by the plaintiffs, but were virtually ignored by the court: increased erosion, susceptibility to damage of Bogue Bank during hurricanes, destruction of the natural beauty of Bogue Bank, interference with eel grasses on Bogue Sound (also a concern of the Department of the Interior), destruction of shellfish and fish life on the bottom of the sound, elimination of habitat of distinctive birds, increased pollution from fishing on the piers and use of the marina by boats, overloading of sanitary sewage systems, and overcommercialization and overcrowding of the island. *See* Brief for Appellants at 3, Rucker v. Willis, 484 F.2d 158 (4th Cir. 1973).

63. Letter from Albert C. Costanzo to Mr. Edward E. Willis, March 22, 1973. The Corps characterized many of the criticisms expressed as problems of local zoning and referred these criticisms to the Carteret County Planning Board. The Planning Board responded that there was *no zoning* of the Willis property (plaintiff's expert testimony showed that residential zoning was imminent for the area). The Corps used the fact that there was no zoning of the area to conclude that no objection from the Planning Board was given. *See* Appendix to Brief for Appellants at 36, Rucker v. Willis, 484 F.2d 158 (4th Cir. 1973).

quately to one component of the CEQ's agency guidelines regarding the NEPA "major federal action—significantly affecting" clause. The guidelines note that a project "is to be construed by agencies with a view to the overall, cumulative impact of the action proposed . . . . [s]uch actions may be localized in their impact, but if there is potential that the environment may be significantly affected, the [impact] statement is to be prepared."[64] In *Rucker* it appears that this "cumulative impact" guideline was used by the court to bolster the merits of the project. The court used the fact that piers already existed to support its decision on the new pier and not to point to the cumulative ill-effects of pier after pier.[65]

This reverse use of the cumulative clause is unusual, yet it is not as great an error as the court's failure to note the possible cumulative effect of the marina and the project as a whole. The complaints of the plaintiffs that raised these issues were ignored by the court. In addition to ignoring the marina's cumulative effect, the court also ignored the CEQ guidelines concerning the "potential" for significant environmental damage. This factor is significant in light of the plaintiff's expert testimony that the project may result in the "[b]reaching of Bogue Bank during a storm, caused by the stabilized area on which the improvements are located focusing the storm energy on the unprotected areas of the Bank on either side."[66] Since no impact statement will now

64. CEQ Guidelines, § 5(b), 36 Fed. Reg. 7724 (1971).

65. Judge Craven in his dissent recognized this infirmity in the court's decision by noting:

> I do not know how many fishing piers are too many, but I think that too many may substantially alter the environment of North Carolina's priceless Outer Banks. It is, of course, true that the issuance of a permit by the Corps to construct a boat dock on an island waterway for a private homeowner is not major federal action requiring the preparation of an impact statement. But what about the 500th such permit, or the 10,000th one? At some point, "zoning" and environmental impact merge. Ecology is largely a matter of land use.

484 F.2d at 164 (Craven, J., dissenting).

Judge Craven found himself in agreement with the Corps' own regulations which favor the threshold test of whether the action "*could* have a significant adverse effect on the quality of the environment, not whether it *would* have such an effect." *Id.* *See also* 37 Fed. Reg. 2525 (1972). Judge Craven felt "the construction of such a fishing pier and marina *could* adversely affect" Bogue Bank. 484 F.2d at 164 (emphasis in original). *See also* Hanly v. Kleindienst, 471 F.2d 823, 831 (2d Cir. 1972). The district court that decided *Rucker* was aware of the cumulative impact guideline, for the court had used it previously in Natural Resources Defense Council v. Grant, 341 F. Supp. 356, 367 (E.D.N.C. 1972) ("The cumulative impact . . . must be considered.") *Contra*, Kisner v. Butz, 350 F. Supp. 310 (N.D.W. Va. 1972).

66. Expert testimony of Orrin H. Pilkey in Appendix to Brief for Appellant at 16. The fact that the court ignored these and other complaints of the plaintiffs', *see* note 62 *supra*, is especially interesting in light of the *Hanly I* statement at text accompanying note 43 *supra*.

be compiled, no further study of that potential danger will be undertaken. Thus the accuracy of the expert testimony can only be tested in one singularly imprudent way—by waiting for a winter storm to occur.

c. The CEQ "Controversial" Guideline. The CEQ guidelines dictate that environmental impact statements should be prepared with respect to "[p]roposed actions, the environmental impact of which is likely to be highly controversial."[67] The court in *Rucker* chose a narrow interpretation of that guideline by rejecting the idea that " 'controversial' must necessarily be equated with opposition."[68] The term, said the court, "should properly refer to cases where a substantial dispute exists as to the size, nature or effect of the major federal action rather than to the existence of opposition to a use."[69] The *Rucker* court followed the majority in *Hanly II* in assuming that "[t]o require an impact statement whenever a threshold determination dispensing with one is likely to face a court challenge . . . would surrender the determination to opponents of a major federal action, no matter how insignificant its environmental effect when viewed objectively."[70]

This perspective flies in the face of the natural meaning of the words.[71] The argument that "substantial dispute [must] exist as to the effect of the action, rather than to the existence of opposition to it"[72] would seem to be based on a play on words, the unmistakable intention of which is to "raise the floor" for the use of the "controversial" test by any plaintiff.

In resorting to such a narrow interpretation of the "controversial" guideline, the *Rucker* court erred in two respects. First, when the guidelines are narrowly interpreted, their effect is unnecessarily limited—and thus their underlying policies are negated. The strength of the policy to encourage the use of impact statements should mandate a broad interpretation of the guidelines. Particularly as to the "contro-

67. CEQ Guidelines § 5(b), 36 Fed. Reg. 7724 (1971).
68. 484 F.2d at 162.
69. *Id.*
70. 471 F.2d at 830 n.9A.
71. *Id.* at 839 (Friendly, C.J., dissenting). Judge Friendly also thought that the "likely to be highly controversial" limitation in the guideline answered the plaintiffs' fears of surrendering the determination to the opponents of a major federal action.
72. Brief for Appellants at 9, Rucker v. Willis, 484 F.2d 158 (4th Cir. 1973). *Hanly II* notes that controversial "apparently refers to cases where a substantial dispute exists as to the size, nature or effect of the major federal action rather than to the existence of opposition to a use, the effect of which is relatively undisputed." 471 F.2d at 830.

versial" guideline, it should be recognized that controversial projects invite lawsuits,[73] and preparing a sound and thorough impact statement may avoid resort to the courts by agency opponents. The final effect of a broad interpretation of the guidelines would be the encouragement of a policy of impact statement preparation that would be beneficial to the agency, the project's opponents, and the environment.[74] Secondly, it is not at all clear that the plaintiff's allegations and the facts in the administrative record fail to meet even the narrow test. Not only was there "opposition" to the Willis project, but the opposition was almost entirely directed at the adverse effects of the project. Controversy for the sake of controversy did not appear to be the plaintiff's intention.[75]

TWO SUGGESTIONS TO PREVENT FUTURE "RUCKERS"

The *Rucker* decision raises doubt as to the future effectiveness of

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73. This factor has been noted by Judge Friendly in his *Hanly II* dissent, 471 F.2d at 839. *See also* Nolop v. Volpe, 333 F. Supp. 1364, 1368 (D.S.D. 1971) ("The mere existence of this lawsuit shows that organized opposition has occurred.") The *Hanly II* majority rejected the suggestion that " 'controversial' must be equated with neighborhood opposition." 471 F.2d at 830.

74. Impact statement preparation would be good for the Corps, for it has been a consistent victim of environmental criticism; beneficial to the environment by possibly providing new information making reconsideration of the project's effects appropriate; and good for the opponents by "allowing opponents to blow off steam and giving them the sense that their objections have been considered—an important purpose of NEPA." 471 F.2d at 839 (Friendly, C.J., dissenting).

75. Regardless of these arguments, however, perhaps the only way to conclude successfully the "controversial" dispute would be for the CEQ to simply omit this proposal from their agency guidelines. The "controversial" guideline is especially inappropriate in threshold impact statement disputes. In *Rucker*, all the project opponents had was a "public notice" of an application which noted that only four weeks were available for comment. Many opponents may have been waiting for a more appropriate stage—perhaps on circulation of the draft impact statement—to comment. In waiting, however, the opponents were foreclosed completely from commenting except in the context of a lawsuit against the Corps for its failure to consider more fully the project's adverse effects. Controversy often takes months to brew, and in its seminal stages it may either be dismissed as temporary and spontaneous opposition or go unnoticed altogether. Yet, the courts may use the initial lack of controversy to restrict severely NEPA's reach. The misuse of this guideline—or a too restrictive interpretation of it —may also be used subtly to shift the NEPA burden off the lead agency and onto a project's opponents, for the guideline has the clear potential of placing an additional burden on environmental plaintiffs. In the case of disputed projects that are not large enough to be obviously "major" or "significant," the project's opponents have, under this guideline, the responsibility to raise a squabble large enough to convince the agency that a controversy exists and that therefore an impact statement is required. Yet the degree to which NEPA is utilized should not depend on a count of the voices raised calling for its use. The NEPA burden is on the lead agencies, not on citizen groups.

Finally, there is something inherently bizarre about a court facing two antagonistic adversaries arguing before it in a ripe dispute and concluding that there is not enough controversy outside the courtroom to allow the plaintiffs to win once they get in.

NEPA in dealing with private projects that require federal permits.[76] Two responses to this uncertainty are available.

First is the possible development of per se categories under NEPA. The application of this concept to the question of major federal actions would, in some instances, effectively insure that NEPA's safeguards would attach. Little case law dealing with this approach exists.[77] Some courts are openly hostile to the per se idea,[78] yet one has "expressed qualified optimism that 'it may be possible in the future to develop some per se categories of major federal actions . . . .' "[79] The activities of several agencies suggests that a per se process has already developed in regard to their projects.[80] However, there is a danger, in the initial development of the per se idea, of thinking too much in terms of agencies rather than in terms of specific projects. A shift to thinking in terms of geographical and ecological areas and activities in those areas should evolve. Not everything a particular agency does should be per se a major federal action, but everything that *any* federal agency does in such an area involving specified destructive activities (*i.e.*, dredging and filling in an estuary, or construction in a flood-plain) should be per se a major federal action.

One frustration for the project's opponents in *Rucker* was the realization that the fragile nature of the estuarine area around Bogue Bank might have been overlooked by the Corps. The delicacy and uniqueness of the estuarine ecosystem is well documented, especially the degree to which an action in one locale may have disasterous consequences perhaps miles away.[81] With this realization, it seems appropriate that NEPA should apply to federal action in an estuarine area on a per se

76. There is already some hostile commentary on applying NEPA to the permitting activities of various agencies. *See* 3 ENVIR. REP. 1434 (March 30, 1973) (NEPA's effectiveness will be "voided" if courts do not recognize that "NEPA was designed to deal with the large, federally financed projects" and not with "governmental regulations of essentially private activities . . . .").

77. For an excellent discussion of the per se concept under NEPA, see NEPA IN THE COURTS 84-87.

78. Transcontinental Gas Pipeline Corp. v. Hackensack Meadowlands Dev. Comm., 464 F.2d 1358, 1366 (3d Cir. 1972).

79. NEPA IN THE COURTS 84, *citing* Sierra Club v. Hardin, 325 F. Supp. 99, 126 n.52 (D. Alas. 1971).

80. *See* NEPA IN THE COURTS 84-87.

81. *E.g.*, 3 FISH & WILDLIFE SERV., U.S. DEPT. OF THE INTERIOR, NATIONAL ESTUARY STUDY, H.R. DOC. NO. 286, Parts I-III, 91st Cong., 2d Sess. (1970); *Proceedings of the North Carolina Inter-Agency Council on Natural Resources*, Nov. 21, 1967; E. Odum, *The Role of Tidal Marshes in Estuarine Production*, in ESTUARINE RESOURCES 14 (1969); Schoenbaum, *Public Rights and Coastal Zone Management*, 51 N.C.L. REV. 1 (1972).

basis. NEPA's impact statement process need not be followed whenever any federal agency did anything anywhere in an estuary. Nevertheless, a more intensive review of how a project is to be done, and what it involves, could be utilized when the project was undertaken in an area such as an estuary, or a redwood forest, or a national park. Especially the more "physically destructive actions"[82] in these areas—such as dredging and filling—could be classified as per se major federal actions. The per se classification would then not develop arbitrarily, but would develop rationally in relation to delicate areas and especially destructive methods in those areas. Resort to an entire estuarine area is certainly not necessary—delineation of specific areas within an estuary would be more realistic. This delineation might easily be accomplished in North Carolina.[83]

A second suggestion to prevent further decisions like *Rucker* grows from the realization that in some instances NEPA may be extended too far. NEPA was clearly not intended—and cannot be expected—to cover every federal action affecting the environment.[84] An overextension of NEPA might retard the progressive development of the statute. To avoid overburdening NEPA, alternatives may be utilized to bolster NEPA's broad environmental scope.

In North Carolina, significant state legislation exists that can be used not only to supplement but also to supplant NEPA. Dredge and fill laws,[85] sand dune regulations,[86] and the state Environmental

82. Brown, *supra* note 6. Brown's notation of Sierra Club v. Mason, 351 F. Supp. 419 (D. Conn. 1972), is interesting in its relation to the per se idea.

83. The need to resort to a more specific delineation is apparent in North Carolina with its 2,200,000 acres of estuaries. The delineation in North Carolina might be accomplished by resort to anticipated 1974 legislation in North Carolina. The North Carolina Coastal Area Management Act of 1973 (H.B. 949; S.B. 614) was carried over by the General Assembly for consideration in 1974. There is some expectation that the bill will pass in 1974 in some form. A central facet of the bill requires the designation of "Areas of Environmental Concern." Such areas might easily be used by federal agencies to represent areas in which federal activity would be subject to a per se categorization for NEPA impact statement purposes.

84. In spite of two commentators' premature conclusion that under NEPA it is already apparent that " 'major' means 'any' and that 'significantly affecting' means 'affecting,' " Cramton & Berg, *supra* note 5, at 518, the cases referred to in note 26 *supra*, show otherwise.

85. N.C. GEN. STAT. § 113-229 (Supp. 1973). The dredge and fill law allows riparian owners to object to the granting of a dredge and fill permit to the Department of Conservation and Development. The statute only allows the permit applicant or any state agency the right to review of their objections before an agency Review Board, with appeal to the superior court of the county where the land is situated. In not granting adjacent riparian owners similar rights to agency and judicial review, the statute seems to be open to constitutional attack.

86. N.C. GEN. STAT. §§ 104B-3 to -16 (1972). The sand dune law, unlike the

Policy Act[87] can regulate activities that are perhaps beyond NEPA's reach. Notice of such state regulation has already been taken by the Fourth Circuit.[88] The plaintiffs in *Rucker* could have resorted to these state laws to enjoin the "leveling of the dunes" and the grant of the state dredge and fill permit. With responsible local action, the state EPA could have been enacted to force the compilation of an impact statement for the *Rucker* project.[89]

The maturation and future vitality of NEPA may be endangered by irritating retrogressions caused by unsuccessful attempts to apply it in areas where it perhaps should not be used at all. Only in developing and using the supplements and alternatives to NEPA, which already exist in many states, can a truly comprehensive and unified body of environmental law—both state and federal—mature and gain strength. By realizing that NEPA need not be alone, future *Ruckers* may be prevented, and judicial determinations of whether NEPA does or does not apply can be rendered less critical in many upcoming environmental disputes.

WILLIAM P. FARTHING, JR.

Federal Estate Tax—"Incidents of Ownership" in Group Life Insurance, A Phrase Searching for Definition

Under section 2042(2) of the Internal Revenue Code of 1954 insurance on the life of a decedent is taxable to the extent that he possessed, at the time of his death, any "incidents of ownership" in the

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dredge and fill statute, allows "any property owner whose property may be damaged" by the granting of a dunes permit a right of appeal to the Board of County Commissioners. Under section 104B-10, the Commissioners' action is "subject to review by the superior court of the county by proceedings in the nature of certiorari." The dunes legislation is intended to prevent any damage that "will not materially weaken the dune or reduce its effectiveness as a means of protection from the effects of high wind and water. . . ." *Id.* § 104B-5. The fact that defendant Willis was able to completely level his dunes bespeaks the weakness of the dunes statute. The statute is in line for a substantial strengthening by the North Carolina General Assembly, however.

87. N.C. GEN. STAT. §§ 113A-1 to -10 (Supp. 1973).

88. Civic Improvement Comm. v. Volpe, 459 F.2d 957, 958 (4th Cir. 1972) (per curiam).

89. *See* N.C. GEN. STAT. §§ 113A-8, -9 (Supp. 1973). By vote of the local governing body, the "action forcing" requirements of the state EPA, *id.* § 113A-4(2) (Supp. 1973), can be applied to local projects that are greater than two contiguous acres in extent.

policy.[1] Since the Code nowhere defines the phrase "incidents of ownership," the courts have been in the process of determining its meaning since it was first used in the 1929 revision of the Regulations under the 1918 Code.[2] Recently the Court of Appeals for the Fifth Circuit, in *Estate of Lumpkin v. Commissioner*,[3] gave the term what may be its broadest meaning. The court held that the mere power to alter the time and manner of enjoyment of the proceeds by the beneficiaries was sufficient to constitute an incident of ownership. While the result of the decision may not be far-reaching, both the court's conclusion and method of analysis seem to be logically inconsistent with other recent decisions which have focused on the meaning of "incidents of ownership."

At the time of his death James H. Lumpkin, Jr. was covered by a non-contributory group term life insurance policy issued to his employer. The terms of the policy provided for the payment of a lump sum of two hundred dollars immediately upon the employee's death plus a series of monthly payments, in an amount equal to one half of the employee's normal monthly compensation, to continue for a period determined by the length of the employee's service with the employer.[4] The beneficiaries of the policy were irrevocably fixed and were of three classes. The wife of the employee, if living at the time of his death, would receive the payments until they were exhausted or until her death. If there were no surviving spouse, payments went to the next of the classes,[5] who, like the spouse, would receive them until their exhaustion or the death of the beneficiary. If all beneficiaries in a class died before the payments were exhausted, the remaining payments did not accrue to the estate of any beneficiary but rather were paid to members of the next class. Because there were only three classes of beneficiaries and because payments terminated on the death of the last of these, there was no assurance that any or all of the amount of the proceeds would be paid by the insurer, and in no case would the proceeds ever be payable to the estate of the insured.

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1. INT. REV. CODE OF 1954, § 2042(2) provides, in pertinent part:
The value of the gross estate shall include the value of all property—
(2) Receivable by other beneficiaries.—To the extent of the amount receivable by all other beneficiaries as insurance under policies on the life of the decedent with respect to which the decedent possessed at his death any incidents of ownership . . . .

2. Treas. Reg. 70, Art. 27 (1929).

3. 474 F.2d 1092 (5th Cir. 1973).

4. *Id.* at 1094 n.5.

5. The next two classes were children of the insured, under twenty-one years

The insured possessed one substantive power over the proceeds of the policy—he could elect an optional mode of payment to his spouse. This option would reduce the amount of each monthly payment and lengthen the period of time over which the payments would be made.[6] For example, he could elect to have the payments reduced by one half and paid for twice as long. In any case the total amount paid to the spouse would remain the same. In the event that the insured elected this mode of settlement and the spouse died before the payments were exhausted, the estate of the spouse would receive the difference between the amount actually received and the amount which would have been paid during that time at the higher rate of payment had the option not been elected. Therefore, Lumpkin possessed only the power to change the time at which the proceeds would be enjoyed; he could not change the amount that any beneficiary (or the estate of that beneficiary) would receive, nor could he exercise any power for his own economic benefit.

The Tax Court held that the very limited power possessed by Lumpkin was not a power to dispose of the property and was not an appropriate subject of the estate tax.[7] The court relied upon the language of Treasury Regulations section 20.2042-1(c)(2) and a 1937 case, *May Billings*,[8] which had held that options as to the modes of settlement that were much broader than were involved in *Lumpkin* did not amount to a "control of the proceeds" and therefore did not result in inclusion.[9]

The court of appeals reversed. Noting that the Code does not define the term "incidents of ownership," the court examined the congressional committee reports[10] that accompanied the enactment of the first predecessor to section 2042.[11] The reports listed illustrative kinds of rights comprehended by the phrase: "the right of the insured to the economic benefits of the policy, the right to change beneficiaries, the right to surrender or cancel the policy, the right to assign the policy, the right to pledge the policy for a loan, and others."[12] The court inferred

of age or permanently incapable of self-support, and parents of the insured. *Id.* at 1093.

6. *Id.* at 1094 n.5.

7. Estate of James H. Lumpkin, Jr., 56 T.C. 815, 824 (1971).

8. 35 B.T.A. 1147 (1937).

9. *Id.* at 1152.

10. H.R. REP. No. 2333, 77th Cong., 2d Sess. 163 (1942); S. REP. No. 1631, 77th Cong., 2d Sess. 235 (1942).

11. Revenue Act of 1942, ch. 619, § 404, 56 Stat. 798, *amending* Int. Rev. Code of 1939, ch. 3, § 811(g), 53 Stat. 122.

12. 474 F.2d at 1095, referring to authorities cited note 10 *supra.*

from this list that Congress intended to tax the value of life insurance proceeds over which the insured at the time of his death still possessed a "substantial degree of control."[13] The inference was strengthened in the eyes of the court by recognition of the congressional intent to give life insurance policies estate tax treatment roughly equivalent to that afforded other types of property under related sections of the Code.[14]

The Commissioner relied upon two relatively more recent cases to offset the impact of *Billings*. The first of these, *Lober v. United States*,[15] held that the forerunner to section 2038[16] required inclusion of the value of the trusts in gross estate where the decedent had created several irrevocable trusts for the benefit of his children but had retained, as trustee, a power to accelerate the remainder. In *Lober* the taxpayer argued that because under state law the beneficiaries had a vested interest in the trust proceeds the power retained by the decedent was not a power to "alter, amend or revoke," but the Supreme Court concluded that the beneficiaries were granted no present right to immediate enjoyment of the trust property and that the degree of control retained by Lober was sufficient to result in inclusion.

In *United States v. O'Malley*[17] the decedent had created several irrevocable trusts for the benefit of members of his family. As one of the trustees, he retained the power to pay the trust income to the beneficiaries or to accumulate it and add it to the principal, in which case the beneficiaries' enjoyment of the income could be postponed and be conditioned upon their surviving the termination of the trusts. The Supreme Court held that this power to alter the time and manner of enjoyment was significant and sufficient to invoke the predecessor to section 2036.[18]

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13. 474 F.2d at 1095.

14. *See* INT. REV. CODE OF 1954, §§ 2036 (transfers with retained life estate), 2037 (transfers taking effect at death), 2038 (revocable transfers), 2041 (powers of appointment).

The only authority cited for this proposition is Estate of Skifter v. Commissioner, 468 F.2d 699 (2d Cir. 1972), discussed at text accompanying notes 34-46 *infra*.

15. 346 U.S. 335 (1953).

16. Int. Rev. Code of 1939, ch. 3, § 811(d)(2), 53 Stat. 122 [hereinafter cited as Int. Rev. Code of 1939].

17. 383 U.S. 627 (1966).

18. Int. Rev. Code of 1939, § 811(c)(1)(B)(ii). Actually the *O'Malley* case dealt specifically with the issue of whether the decedent had ever "transferred" the trust income. The proposition for which the case was cited in *Lumpkin* was deemed by the *O'Malley* court to have been decided in Commissioner v. Estate of Holmes, 326 U.S. 480 (1946), and nothing in the *O'Malley* decision added to or detracted from the proposition adopted in *Holmes* that the type of power held by the decedent

Based on these cases, the *Lumpkin* court concluded that the power to alter the time and manner of enjoyment gives its holder a substantial degree of control, at least for purposes of sections 2036 and 2038. In view of the congressional intent to make the estate tax treatment of life insurance proceeds similar to that of other types of property, the court felt it would be anomalous to hold that such a power is not also an incident of ownership within the meaning of section 2042. In the view of the *Lumpkin* court, the only significant distinction between sections 2036 and 2038, on the one hand, and section 2042, on the other, is that the former require an incomplete transfer while under the later a transfer is unnecessary. Thus sections 2036 and 2038 deal with powers *retained*[19] by the decedent over property that he initially transferred, while under section 2042 the decedent at death need merely *possess* an incident of ownership. The means by which he came into possession was considered irrelevant.[20] *Lumpkin* found that this distinction does not imply any further differences among the sections as to the degree of power the decedent must hold over the property in order to render its value includible in his gross estate. Accordingly, the court held that Lumpkin possessed an "incident of ownership" in the insurance policy.

The court concluded by stating that Lumpkin could have assigned the right to select the optional modes of settlement, divesting himself of the power and thereby avoiding the estate tax on the proceeds.

Arguably, *Lumpkin* will have little practical effect upon those who are covered by group term life insurance policies. A recent comment[21] points out that it should be relatively simple for employers who are concerned with the estate tax consequences of the decision to re-write the insurance policies so as to require their employees to make an irrevocable designation of the mode of settlement and thereby divest the insured of the power. However, the court's suggestion that the employee

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in that case was significant. Indeed the *Lumpkin* court's reliance on *O'Malley* in this context is completely misleading. It is arguable that *Lober*, which also relied strongly upon *Holmes*, added nothing to the law in this regard and that the mere ability to determine the time and manner of enjoyment of transferred property had been held to be sufficient to result in inclusion in the gross estate of the transferee as early as 1946. The significance of this possibility is discussed at text accompanying note 54 *infra*.

19. This interpretation of section 2038 is not consistent with the literal wording of that provision, but does appear to be consistent with the interpretation given the section by the Second Circuit in *Skifter*, discussed at text accompanying notes 34-46 *infra*.

20. 474 F.2d at 1097.

21. 10 HOUSTON L. REV. 984, 986 (1973).

assign the right to select the optional modes of settlement is potentially dangerous. The cases clearly indicate that if such an assignment is made solely for the purpose of avoiding the estate tax and the insured dies within three years of the assignment, section 2035 (transfers made in contemplation of death) will operate to include the value of the proceeds.[22]

The estate tax treatment of life insurance on the life of the decedent payable to other beneficiaries has had a varied history.[23] Life insurance is one of the only forms of property given special treatment in a separate Code section and when section 2042(2) is compared to related sections of the Code it is apparent that life insurance is treated very differently from other property.[24] Some commentators view the IRS attitude toward life insurance as unfavorable;[25] it certainly appears that the Service has been attempting to push the definition of "incidents of ownership" to the outer limits in recent cases.[26] The broad interpretation given to the phrase by the *Lumpkin* court, therefore, will be important in two respects. Those who favor a more lenient estate tax treatment of life insurance will see it as potentially dangerous precedent and those who take the opposite view will be concerned that the

22. *See, e.g.*, Slifka v. Johnson, 161 F.2d 467 (2d Cir. 1947); Vanderlip v. Commissioner, 155 F.2d 152 (2d Cir. 1946); First Trust & Deposit Co. v. Shaughnessy, 134 F.2d 940 (2d Cir. 1943).

23. *See generally* C. LOWNDES & R. KRAMER, FEDERAL ESTATE & GIFT TAXES ch. 13 (1962); 2 J. MERTENS, THE LAW OF FEDERAL GIFT AND ESTATE TAXATION § 17 (1959). Courts have held the following powers to be incidents of ownership: the power to change the beneficiary or assign the policy, Commissioner v. Noel, 380 U.S. 678 (1965); the power to surrender or cancel the policy, Commissioner v. Treganowan, 183 F.2d 288 (2d Cir.), *cert. denied*, 340 U.S. 853 (1950); the power to borrow against the policy from the insurer, Fried v. Granger, 105 F. Supp. 564 (W.D. Pa. 1952), *aff'd*, 202 F.2d 150 (3rd Cir. 1953). However, it has been held that the power to terminate group life insurance solely by terminating employment is not an incident of ownership; *see* Landorf v. United States, 408 F.2d 461 (Ct. Cl. 1969); Estate of James H. Lumpkin, Jr., 56 T.C. 815 (1971); Rev. Rul. 72-307, 1972-1 CUM. BULL. 307.

24. *See* Lowndes, *An Introduction to The Federal Estate and Gift Taxes*, 44 N.C.L. REV. 1, 13 (1965).

25. Wilson, *Equal Treatment for Life Insurance*, 112 TRUSTS & ESTATES 270 (1973).

26. In Estate of James H. Lumpkin, Jr., 56 T.C. 815 (1971), the Commissioner argued that not only the power to select the optional mode of settlement but also the power to cancel the insurance by terminating employment, the power to convert the policy upon termination of employment, and the power to assign all rights under the policy were incidents of ownership. The court rejected all of these arguments and they were not pursued on appeal. In Landorf v. United States, 408 F.2d 461 (Ct. Cl. 1969), the Commissioner had also been unsuccessful in these arguments. Rev. Rul. 72-307, 1972-1 CUM. BULL. 307, reflects the acceptance by the I.R.S. of the proposition that the power to cancel group term life insurance by terminating employment is not an incident of ownership.

decision does not deal with some of the arguments which will be raised, as they have been in prior cases, to support a more limited definition of "incidents of ownership."

Two other recent cases which have focused on the meaning of the term "incidents of ownership" illustrate a different approach from that taken by the court in *Lumpkin* and reach a result which seems to be logically inconsistent with it. In *Estate of Fruehauf v. Commissioner*[27] the wife of the decedent had owned certain insurance policies on her husband's life. However, she predeceased him by fourteen months, leaving a will that established a trust to which the life insurance policies passed. As co-executor of the wife's estate and co-trustee of the trust, Fruehauf had powers in a fiduciary capacity over the insurance policies which would clearly have been incidents of ownership under other circumstances. The Tax Court held that the proceeds were includable in Fruehauf's gross estate.[28] It rejected the contention that the capacity in which the powers are held should be significant in determining whether they were sufficient to constitute incidents of ownership.[29]

The Sixth Circuit affirmed, but the court rejected what it termed a "broad *per se* rule" that possession of powers sufficient to constitute incidents of ownership would always result in the inclusion of the proceeds of policies, regardless of the fact that the powers were held in a fiduciary capacity.[30] The court focused on the fact that where the decedent was a transferee of the powers but could not exercise them for his own economic benefit, such an arrangement can hardly be construed as a substitute for testamentary disposition on the decedent's part.[31] The court then stated that the Tax Court had ignored the fundamental nature of the fiduciary relationship, citing previous cases which had recognized that the capacity in which incidents were held was important.[32] The Sixth Circuit concluded that since the decedent was the lifetime beneficiary of the testamentary trust established by his wife, he had the ability to exercise the powers in such a way as to give himself the economic benefit of the life insurance. It was this dual

27. 427 F.2d 80 (6th Cir. 1970).
28. Estate of Harry R. Fruehauf, 50 T.C. 915 (1968).
29. *Id.* at 926.
30. 427 F.2d at 83-84.
31. *Id.* at 84; *cf.* Porter v. Commissioner, 288 U.S. 436, 444 (1933); Commissioner v. Chase Nat'l Bank, 82 F.2d 157, 158 (2d Cir. 1936).
32. Estate of Bert L. Fuchs, 47 T.C. 199 (1966); Estate of Newcomb Carlton, 34 T.C. 988 (1960), *rev'd on other grounds*, 298 F.2d 415 (2d Cir. 1962).

position as fiduciary and beneficiary under the will and trust instrument that gave Fruehauf incidents of ownership in the policies and required inclusion of their proceeds in his gross estate.[33]

Estate of Skifter v. Commissioner[34] dealt with a similar situation. Here the decedent had owned the insurance policies but more than three years before his death he had divested himself of all interest in and power over them by assigning them to his wife. As in *Fruehauf*, the wife had pre-deceased the insured and had left a will which set up a trust containing the policies and naming the insured as trustee. Skifter's powers as trustee were not so broad as those of Fruehauf since Skifter could not exercise any power for his own economic benefit. Nevertheless, the Commissioner argued that the decedent possessed incidents of ownership in the policies and that they should be included in his gross estate under section 2042(2). The *Skifter* court cited the same list of examples of incidents of ownership which the *Lumpkin* court had examined,[35] but in *Skifter* the court also noted the language of Treasury Regulations section 20.2042-1(c)(2) which read in part:

> Generally speaking, the term [incidents of ownership] has reference to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy . . . .[36]

This language is almost identical to that found in the congressional committee reports, but there is an important distinction. The committee reports merely include the right to economic benefit from the policy as one example of powers and rights which might constitute incidents of ownership, whereas the regulations state that an incident of ownership has reference to the right to economic benefit and thus includes several other rights and powers the possession of which arguably constitutes a right to economic benefit.[37] The court obviously

33. 427 F.2d at 86.
34. 468 F.2d 699 (2d Cir. 1972).
35. *See* note 12 and accompanying text *supra*.
36. Treas. Reg. § 20.2042-1(c)(2) (1958).
37. Clearly the power to pledge the policy for a loan or to obtain a loan from the insurer against the surrender value of the policy involves a right to economic benefits from the policy. Whether the other rights and powers mentioned involve economic benefits will depend upon the nature of the insurance and the terms of the policy, *e.g.*, unless the power to change the beneficiary is restricted it includes the power to designate the estate of the insured as beneficiary, and this may be an economic interest. Similarly, the power to assign the policy may be a right to eco-

focused upon the wording of the regulations because it found significant the fact that Skifter could not have exercised any of his powers for his own economic benefit.[38]

The predecessor to section 2042 provided that even if the decedent divested himself of all interest in an insurance policy on his life, the proceeds would still be included in his gross estate if he had continued to pay the premiums on the policy.[39] This provision was dropped from the Code in 1954, and in the congressional comittee reports[40] accompanying the enactment of section 2042 the *Skifter* court found language which indicated that in dropping the "payment of premiums" test Congress intended to give life insurance treatment more nearly equal to that afforded other types of property under the estate tax.[41] While recognizing that this legislative history was hardly conclusive, the court felt that it gave support to the argument that in defining "incidents of ownership" the courts should examine the treatment given other property under sections 2036, 2037, and 2038.

Treasury Regulation section 20.2042(c)(4) provides, in part

> A decedent is considered to have an "incident of ownership" in an insurance policy on his life held in trust if, under the terms of the policy [he] . . . has the power [as trustee or otherwise] to change the beneficial ownership in the policy or its proceeds, or

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nomic benefit if the nature of the policy is such that an assignment would have any value. It is difficult to determine what significance should be attached to this difference in wording between the committee reports and the Treasury Regulations. *See* Note, *Estate Taxation of Life Insurance Policies Held by the Insured as Trustee*, 32 MD. L. REV. 305, 310 n.23 (1972).

38. 468 F.2d at 702. There is support in the cases for the proposition that incidents of ownership refer to a right to economic benefits from the policy; *see, e.g.*, Chase Nat'l Bank v. United States, 278 U.S. 327 (1929); Prichard v. United States, 397 F.2d 60 (5th Cir. 1960); Commissioner v. Chase Manhattan Bank, 259 F.2d 231 (5th Cir. 1958). *But see* United States v. Rhode Island Hosp. Trust Co., 355 F.2d 7, 11 (1st Cir. 1966), discussed in note 50 *infra*.

39. Revenue Act of 1942, ch. 619, § 404, 56 Stat. 798.

40. The committee stated that the "payment of premiums" test was dropped because no other type of property was subject to the estate tax where the decedent purchased it but gave it away long before his death "and because to discriminate against life insurance in this regard is not justified." The 1954 Code also incorporated into section 2042(2) the section 2037 rule that a reversionary interest in the property qualifies for inclusion if the value of the interest exceeds five per cent of the value of the property; this was done to place "life insurance policies in an analogous position to other property . . . ." S. REP. No., 1622, 83d Cong., 2d Sess. 124 (1954).

41. 468 F.2d at 702. The court found additional support for the proposition that life insurance was intended to receive treatment similar to that afforded other types of property in the fact that the interests and powers which Congress included as examples of incidents of ownership were similar to those which would result in inclusion of other property under other sections of the Code.

> the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust.[42]

The *Skifter* court agreed with the Tax Court[43] that if this section were given its broadest reading it would conflict with Regulation section 20.2042(c)(2), but it rejected a broad reading where the decedent had possessed no power to benefit himself or his estate.[44]

Although the Second Circuit agreed that section 2042 should be read in light of related sections of the Code and recognized that the literal language of section 2038 provides that the section will result in taxation "without regard to when or from what source the decedent acquired" the power, it pointed out that the legislative history of that language indicated it was intended to apply only to the situation where the decedent himself created a power in someone else at the time of transfer and which later devolved upon him before his death.[45]

The court concluded that because none of the other code sections would have taxed the policies had they been other property and because Congress did not intend to discriminate between life insurance and other forms of property the powers possessed by Skifter at his death did not constitute incidents of ownership.[46]

There is apparent disparity between the holdings in *Lumpkin* on the one hand and *Fruehauf* and *Skifter* on the other. The disparity might best be characterized in terms of the dichotomy between the inference in *Lumpkin* that any significant power over the proceeds of an insurance policy alone constitutes an incident of ownership and the implicit recognition in *Fruehauf* and *Skifter* that there is a further test which must be applied—that certain powers are not within the purview

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42. Treas. Reg. § 20.2042(c)(4) (1958).

43. Estate of Hector R. Skifter, 56 T.C. 1190, 1198 (1971).

44. 468 F.2d at 703. There appear to be three alternative ways in which Treas. Reg. § 20.2042-1(c)(4) may be reconcilable with § 20.2042-1(c)(2). First, the language of (c)(2) which reads "generally speaking . . . economic benefits" does not preclude the possibility of non-beneficial interests. Second, (c)(4) may be read as applying only to the situation where the decedent retains powers over policies transferred in trust. Third, since (c)(4) is the only section of the regulations which speaks of policies *held* in trust the section may apply only to a policy which is placed in trust regardless of whether the insured retained the power or himself made the transfer to the trust. The *Skifter* courts considered only the first and second possible constructions—the third alternative, if accepted, would have governed in *Skifter*. This analysis of Treas. Reg. § 20.2042(c)(4) is found in an excellent criticism of the opinion of the *Skifter* court: Note, 32 MD. L. REV., *supra* note 37, at 309.

45. 468 F.2d at 705. This interpretation of section 2038 is subject to criticism, *see* Note, 32 MD. L. REV., *supra* note 37, at 313-18. The *Lumpkin* court, however, seems to have accepted this interpretation, *see* note 14 *supra*.

46. 468 F.2d at 705.

of the "incidents of ownership" test, even though they may give the insured very real control over the policy or its proceeds.

One aspect of the latter viewpoint would certainly be the focus of the Tax Court in *Lumpkin* on the *de minimis* nature of the right held by the decedent. There are some powers which the insured may possess which give him such a small degree of control that they have been held to be insufficient to constitute incidents of ownership even though they are certainly property rights in the broad meaning of the term.[47]

Another aspect of this test involves the recognition that the source of the power in question is significant. If the reasoning of *Fruehauf* and *Skifter* is accepted it might well be concluded that Lumpkin was as much the transferee of the power which he held as were the decedents in those two cases. The language of section 2042(2) provides that taxation will result where the decedent "possessed" an incident of ownership, but this language did not preclude the *Fruehauf* or *Skifter* court's examination of the source of the power.

Perhaps more important is the *Lumpkin* court's failure to deal convincingly with the argument that an incident of ownership refers to a right to economic benefits from the insurance. As attorneys for the taxpayer argued in their brief,[48] there is a long line of cases equating incidents of ownership with beneficial interest.[49] This was certainly important in both *Fruehauf* and *Skifter*, and might well be one line of demarcation in a proper definition of "incidents of ownership." Because the *Lumpkin* decision departs from this trend, the court would have done well to treat the issue directly, and they would have found some support in a few cases which have rejected the argument that lack of beneficial interest will always prevent a power from being an incident of ownership.[50]

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47. *See* note 26 *supra*.

48. Brief for Appellee at 11, Estate of Lumpkin v. Commissioner, 474 F.2d 1092 (5th Cir. 1973).

49. *See* cases cited note 38 *supra*.

50. *See* United States v. Rhode Island Hosp. Trust Co., 355 F.2d 7, 11 (1st Cir. 1966). This case was mentioned in the opinion of the Tax Court in *Skifter* but was found to deal with an entirely different kind of situation and to offer only superficial support to the contention of the government that an incident of ownership need not give the insured the right to economic benefits from the policy. 56 T.C. at 1198 n.2.

The court might also have examined Treas. Reg. § 20.2042-1(c)(4) in light of the analysis contained in note 44 *supra*. If the court had accepted the first alternative discussed there and used that interpretation of the Regulation to bolster its rejection of the contention that an incident of ownership always refers to a beneficial interest,

Neither the *Skifter* nor *Lumpkin* courts found conclusive support for the proposition that Congress intended, in enacting the 1954 Code, to give life insurance more nearly equal treatment to that afforded other types of property. As mentioned previously, the only support which the court in *Skifter* found for this proposition was the language of the congressional committee reports dealing with the dropping of the payment of premiums test,[51] and the *Lumpkin* opinion cites only *Skifter* as authority. As a general proposition, the validity of the inference by the *Skifter* court from the language of the reports may have some merit,[52] but in the context of *Lumpkin* it is open to serious question. The *Billings* decision had been acquiesced in by the Commissioner in 1937,[53] and this acquiescence was outstanding at the time of the *Lumpkin* decision. The *Lober* case cited by the *Lumpkin* court was handed down in 1953, and the proposition for which *O'Malley* was cited in *Lumpkin* had actually been decided in 1946.[54] Since the Supreme Court had determined *before* the enactment of the 1954 Code that the mere power to alter the time and manner of enjoyment of transferred property was sufficient to result in inclusion under the forerunners to sections 2036 and 2038, it might be argued that had Congress intended to apply the same test to incidents of ownership, it would have done so directly rather than in the vague wording in a congressional committee report, and that since it had not done so the *Billings* decision should stand.

However, assuming that Congress did intend to make the estate tax treatment of life insurance more nearly parallel to that given other types of property under related sections of the Code, the *Lumpkin* decision may be subject to even more criticism. The entire scheme of the federal estate tax rests upon the basis of a tax on the privilege of transferring property at death coupled with "taxes upon other types of transfers that have some of the aspects of a testamentary transfer and would otherwise be resorted to in order to escape a tax limited to strictly testamentary transfers."[55] Thus in interpreting section 2042 and related sections of the Code the courts should consider whether the

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this argument, coupled with the language from the *Rhode Island Hosp. Trust Co.* opinion would have been a much more persuasive method of dealing with a concept on which has been founded the rejection of many of the Government's attempts to include non-beneficial powers as incidents of ownership.

51. Note 40 *supra.*

52. *See* Note, 32 MD. L. REV., *supra* note 37, at 306 n.25.

53. 1937-2 CUM. BULL. 3, *withdrawn*, 1972-2 CUM. BULL. 3.

54. Note 18 *supra.*

55. Lowndes, *supra* note 24, at 4.

transfer or power at issue appears to be a "substitute for testamentary disposition of property."[56]

An examination of the Code will reveal that with the exception of sections 2040, 2041 and 2042, all of the sections require that the decedent have made an incomplete transfer of the property, which necessarily implies that he have had beneficial interest in it. Section 2040 taxes jointly held property to the extent that the consideration for it was furnished by the decedent, and thus reaches a situation where the decedent transferred property which he owned in exchange for property which is held jointly. Section 2041 taxes property over which the decedent had a general power of appointment—a power exercisable for the benefit of himself or his estate. It is thus apparent that section 2042 is the only section which can be read to reach property which the decedent neither owned nor had any beneficial interest in and over which he never had any power exercisable for his own benefit or that of his estate.[57] Since Congress has rejected the contention that life insurance is inherently testamentary,[58] it seems only logical that if Congress did intend to remove the discriminatory aspects of life insurance taxation under the Code, it intended that an incident of ownership be equated with the right to economic benefits of the policy. If this interpretation is given to the phrase, an incident of ownership may be seen as similar to an incomplete transfer of the property (in the situation where the insured has beneficial interest in the property but transfers it, retaining a life estate, power to revoke, etc.) or a general power of appointment (where the decedent never owned the policy but was given a power exercisable for the benefit of himself or his estate).

By equating the nature of the power required under sections 2036 and 2038 with that required by section 2042 but ignoring the distinctions between the types of property involved, the *Lumpkin* court reached a decision which is clearly contrary to what the court itself saw as congressional intent. The court also failed to read correctly the focus of the *Skifter* opinion which it cited as authority for this view of

56. *See* Porter v. Commissioner, 288 U.S. 436, 444 (1933); Commissioner v. Chase Nat'l Bank, 82 F.2d 157, 158 (2d Cir. 1936); H.R. REV. No. 767, 65th Cong., 2d Sess. 22 (1919).

57. Certainly the insured may have possessed a beneficial interest in a life insurance policy, and in the case where he purchases the policy himself and later transfers it, it is difficult to distinguish this form of property from any other with respect to its treatment under the estate tax. Only in the case of an insured who did not himself purchase the insurance, such as in the group life insurance situation, is the *Lumpkin* court's result obviously discriminatory toward life insurance.

58. H.R. REP. No. 1337, 83rd Cong., 2d Sess. A316-17, B14-15 (1954).

congressional intent, for *Skifter* had asked whether the property would be taxed under other sections of the code if it were not life insurance, not whether the power held by the decedent would have been sufficient under those sections to result in inclusion. This distinction is critical, for the former statement of the issues requires the court to examine, in addition to the nature of the power, the source of the power, the way in which it is held, and whether the arrangement is a substitute for testamentary disposition of the property.

Implicit in the *Lumpkin* court's decision is the view that even though life insurance is not always inherently testamentary, it has testamentary characteristics which may justify taxation in situations where other forms of property would not be taxed. Whether this premise is valid is open to question in view of the refusal of Congress to treat life insurance as inherently testamentary, but even if the premise is accepted the court did little to provide guidelines for applying it to other situations. The factors which other courts have viewed as important in defining "incidents of ownership" are neither integrated into the *Lumpkin* result nor rejected outright; this should allow wide latitude for other courts to distinguish the decision.

Lumpkin is an apparent success for the contention of the Service that powers sufficient to result in inclusion under other sections of the Code are sufficient to constitute incidents of ownership, but it does little to provide a workable definition of "incidents of ownership" and may only inject more confusion into this unsettled area of the law.

STEVEN KROPELNICKI, JR.

Federal Income Tax—Internal Revenue Code Sections 167 and 263—Depreciation on Depreciation?

Section 167 of the Internal Revenue Code allows the taxpayer a deduction from gross income for depreciation of certain property used in his business.[1] Section 263 forbids the deduction of any amounts

1. INT. REV. CODE OF 1954, § 167, provides in part:
(a) General Rule.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—
(1) of property used in the trade or business, or
(2) of property held for the production of income.
Prior versions of section 167, applicable to cases discussed in the text, are comparable.

paid out as capital expenditures and improvements,[2] although those capital expenditures might themselves be depreciable. Amounts paid out for such expenditures include acquisition and construction costs.[3] Recently, in *Idaho Power Co. v. Commissioner*,[4] the question arose whether construction costs to be capitalized might include depreciation incurred on a taxpayer's equipment during the construction of its own capital properties. The Ninth Circuit Court of Appeals held against capitalization of construction equipment depreciation.

The taxpayer in *Idaho Power* was a public utility that normally built additions to its own primary electrical transmission and distribution lines and stations. During the taxable years 1962 and 1963, Idaho Power had charged to plant accounts all depreciation and operating expenses incurred on its equipment to the extent it was used in construction of new lines.[5] The depreciation thus capitalized on the books totalled 280,571.41 dollars on equipment with a composite life of ten years. On its federal tax returns the taxpayer deducted all depreciation incurred during these periods, including that allocated on its books to construction. The I.R.S. disallowed a substantial portion of the deduction, but did allow the depreciation to be added to the depreciable portion of the facilities constructed and thus to be deducted over the useful lives of the facilities, all of which were expected to last at least thirty years.[6]

On appeal to the Tax Court from the deficiency,[7] Idaho Power contended that the depreciation should be entirely deductible in the years it was incurred since the equipment was used in its "trade or business" within the meaning of section 167.[8] The government countered that construction of power facilities was not within the scope of

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2. INT. REV. CODE OF 1954, § 263, provides in part:
   (a) General Rule.—No deductions shall be allowed for—
      (1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

In specific exclusions which follow, no mention is made of electric utilities. Forerunner provisions are comparable.

3. Treas. Reg. § 1.263(a)-2(a) (1958).

4. 477 F.2d 688 (9th Cir.), *cert. granted*, 94 S. Ct. 351 (1973) (No. 263).

5. Although on its books the taxpayer capitalized depreciation as well as maintenance and other equipment operating expenses, it deducted as expenses pension contributions, Social Security tax, and motor vehicle tax. 477 F.2d at 690.

6. It should be noted that the mere allowance of capitalization does not necessarily permit subsequent deduction (through amortization) of the particular cost. *E.g.*, Treas. Reg. § 1.167(a)-3 (1960) (goodwill).

7. Idaho Power Co., 39 P-H Tax Ct. Mem. 427 (1970).

8. *Id.* at 429; *see* INT. REV. CODE OF 1954, § 167(a)(1).

the taxpayer's trade or business and that even if it were, the current deduction of any capital expenditure in connection with trade or business is prohibited by section 263. The Tax Court held for the Commissioner and focused on section 263 in requiring capitalization.

The court of appeals directed its attention to section 167 and found the "trade or business" determination to be crucial.[9] It reversed the Tax Court and held that immediate deduction of this type of depreciation is allowable.

When the depreciation-capitalization problem had previously been addressed, the courts had split. In 1927, the Board of Tax Appeals decided *Great Northern Railway*[10] which involved depreciation of trains and equipment already owned but used occasionally for transporting employees to railway construction sites. The workers were carried on regularly scheduled runs. The Board held that any operating expenses, incremental or not, which could possibly be allocated to construction must not be deducted immediately. Specifically, the court disallowed the portion of the depreciation deduction allocable to construction work. In so doing, the court held that "a part of the wear and tear of the train equipment, of the rails, ties, etc., may be properly capitalized."[11]

A few years later, the same railway brought the same question

9. 477 F.2d at 696. As to the weight accorded court of appeals decisions by the Tax Court, *compare* Jack E. Golsen, 54 T.C. 742, 756-57 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971) (will follow the court of appeals for its circuit if squarely in point), *with* Estate of George I. Speer, 57 T.C. 804, 812 (1972) (will not follow if a different state is involved), *and* Donald W. Fausner, 55 T.C. 620, 626 (1971). Also, the judges of the Tax Court do not bind each other by their decisions unless they are reviewed by the court as a whole. Comment, *Toward New Modes of Tax Decision Making*, 83 HARV. L. REV. 1695, 1700 n.30 (1970).

10. 8 B.T.A. 225 (1927), *aff'd*, 40 F.2d 372 (8th Cir.), *cert. denied*, 282 U.S. 855 (1930). A strong analogy can be drawn between railroads and electric companies, and between railway tracks and power lines. Both industries are regulated, and expansion and replacement of facilities have been a major part of their businesses.

11. 8 B.T.A. at 263 (even though the Board also found the depreciation to have been incurred in the railroad's regular business). I.R.S. disallowance of current depreciation deductions was particularly onerous to railroads since they commonly used the "retirement" method for reporting. Under this method, capitalized acquisition costs are not depreciable over time. Only when restoration and replacement charges exceed half the current replacement cost of the asset may the original cost be deducted from revenues. Since the original cost contains the depreciation on equipment from the construction period, recovery of that depreciation cost free of taxes was postponed drastically. 4 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 23.37 (rev. 1969). *But see* INT. REV. CODE OF 1954, § 263(e) (added in 1969). Note, however, that replacements (as opposed to originals) of railroad track were customarily treated as current expenses, *e.g.*, Union Pac. R.R. v. United States, 99 U.S. 402, 421 (1878).

back to the Board of Tax Appeals.[12] During 1928, 1929, and 1930, Great Northern Railway incurred depreciation on equipment that it was again using "in the construction of additions to or betterments of" its property.[13] As prescribed by Interstate Commerce Commission directives, the railway had added this depreciation to the cost of the assets on its books, but for tax purposes it deducted all the depreciation immediately. The Board allowed the deduction as a matter of course once it found the equipment to have been used in a trade or business.[14]

In this second *Great Northern* case, the court did not explore the section 263 capitalization problem because the government brief had failed to cite the first *Great Northern* case, key precedent in support of capitalization.[15] This omission by the Commissioner was interpreted by the Board as an indication that the I.R.S. was abandoning its traditional position favoring capitalization. The I.R.S. had not, in fact, abandoned that policy and referred in its brief many years later in *Southern Natural Gas Co. v. United States*[16] to "the Board's mistaken view that the Commissioner's unexplained failure to cite the first Great Northern decision meant that he repudiated its authority."[17]

The taxpayer in *Southern Natural Gas* was an interstate gas carrier that built new pipelines to expand its system. Some of the equipment that it owned primarily for maintenance and operation was used from time to time to construct additional facilities. The Court of Claims held that depreciation allocable to the use of the equipment in construction was not a proper current deduction but should be capitalized and recovered over the lives of the new pipelines. Although the results in *Southern Natural Gas* and *Idaho Power* are divergent, in both cases the courts relied on the section 167 trade or business test. This approach had been adopted by the court in *Northern Pacific Railway*

12. Great N. Ry., 30 B.T.A. 691 (1934) [hereinafter referred to as the second *Great Northern* case].

13. *Id.* at 707.

14. *See* 477 F.2d at 694. The Board of Tax Appeals which had decided the second *Great Northern* later expressly limited that holding to precisely this point, that the depreciation was incurred in trade or business since it is part of a railroad's regular business to construct additional capital facilities for doing business as a common carrier. Producers Chem. Co., 50 T.C. 940, 960 (1968).

15. 30 B.T.A. at 708.

16. 412 F.2d 1222 (Ct. Cl. 1969).

17. *Id.* at 1268 n.78. The I.R.S. has successfully defended this position in Northern Pac. Ry. v. Helvering, 83 F.2d 508 (8th Cir. 1936); Churchill Farms, Inc., 38 P-H Tax Ct. Mem. 1071 (1969); Ben Perlmutter, 44 T.C. 382 (1965), *aff'd*, 373 F.2d 45 (10th Cir. 1967).

v. Helvering,[18] an earlier case in which transportation expenses borne by the railroad in constructing additions were held to be allocable to capital items. The approved allocation formula included "wear and tear (i.e., depreciation) of the train equipment,"[19] even though the expenses were not incurred in pursuance of the railroad's duty as a public carrier but as a private owner of property.[20]

No mention of "trade or business" is made in Revenue Ruling 59-380[21] nor in Revenue Ruling 55-252,[22] both of which require capitalization. Ruling 59-380 was written in response to an inquiry from a taxpayer who used already owned and newly acquired construction equipment for his own capital improvements. This ruling was expressly approved in *Southern Natural Gas*.[23] Ruling 55-252 required depreciation of trucks and equipment used in reforestation to be capitalized in the cost of the trees and recovered tax-free through depletion allowances. Neither of these rulings has been rescinded by the Commissioner.[24]

There are limits, however, to the government's favor of capitalization.[25] The 1970 reversal of *L.W. Brooks, Jr.*[26] by the Fifth Cir-

18. 83 F.2d 508 (8th Cir. 1936).

19. *Id.* at 513, *quoted and clarified in* Southern Natural Gas v. United States, 412 F.2d 1222, 1267 (Ct. Cl. 1969).

20. 83 F.2d at 514. The distinction drawn here between actions within and without the role of common carrier for tax purposes was based upon the same distinction as drawn in Santa Fe P. & P. Ry. v. Grant Bros. Constr. Co., 228 U.S. 177 (1913) for tort and contract liability purposes.

21. 1959-2 CUM. BULL. 87:

> Depreciation sustained on construction equipment owned by a taxpayer and used in the erection of capital improvements for its own use is not an allowable deduction, but shall be added to and made a part of the cost of the improvements. So much thereof as is applicable to the cost of depreciable capital improvements is recoverable through deductions for depreciation over the useful life of such capital improvements.

22. 1955-1 CUM. BULL. 319.

23. 412 F.2d at 1268. The *Idaho Power* court rejects the ruling, however, basing its rejection on (1) its perceived invalidity of *Southern Natural Gas*, and (2) its limited regard for revenue rulings. 477 F.2d at 696 & n.10. As to the second point, *see* Bartels v. Birmingham, 332 U.S. 126, 132 (1947); Stubbs v. United States, 445 F.2d 1142, 1146-47 (5th Cir. 1971); *cf.* Overbey v. United States, 44 F.2d 268 (Ct. Cl. 1930); Arthur H. Lamborn, 13 B.T.A. 177 (1928). *But see* 1 J. MERTENS, *supra* note 11, at § 3.20: "If, however, a ruling reflects a position not departed from by the Treasury Department over a period of many years, it is entitled to serious consideration by the courts."

24. Rev. Rul. 69-228, 1969-1 CUM. BULL. 29, cites Rev. Rul. 59-380 as still in force. Rev. Rul. 55-252 has not been rescinded to date.

25. Although not a limitation, note that the Commissioner will not allow capitalization of construction depreciation for investment credit purposes when the additions are new section 38 property. "New section 38 property" is depreciable tangible property (other than buildings) with a useful life of three years or more which is completed after Dec. 31, 1961. INT. REV. CODE OF 1954, § 48(b).

26. 50 T.C. 927 (1968), *rev'd*, 424 F.2d 116 (5th Cir. 1970).

cuit indicates that when depreciation and other expenses are incurred in recovering minerals, capitalization or deduction of those expenditures may hinge on the type of "estate" involved.[27] Customarily, oil leases are divided into the financing interest and the operating interest. The lease owner sells to the operator a "working interest" in the land in return for the operator's promise to pay the owner a set amount out of the oil produced, if any, during the early stages of production. Risk is thus borne by both parties. If expenses of operation, such as depreciation, are added to the basis of the oil in the ground in which the production payment owner has an interest, he would enjoy a tax advantage upon the sale of that oil. If, on the other hand, such expenses are deducted by the operator, he would reap the tax benefits.

Capitalization might be proper only to the extent the expenditures add to the estate of the production payment owner. Normally, however, these expenditures in raising oil add nothing to the interest itself but merely accelerate payment. Although the operator's costs of raising oil that is allocable to production payments can be considered costs of acquiring the capital asset and thus properly capitalized (on the theory that the operator has simply paid the production payment owner's share of costs), the appellate court disallowed capitalization. Operators may currently deduct all operating expenses, even if a net loss results, because "the proper allocation of where the operating expense burden [and the tax benefit lie] depends on the type of legal estate or interest involved"[28] and because a basic characteristic of a production payment interest is its freedom from operating expenses. Such expenses are, rather, an attribute of the working interest in the land.[29]

If depreciation adds to the estate, it should be capitalized even though it might be considered an "intangible" cost. The court in *Idaho Power* discussed the problem of transmuting an intangible expense into tangible property. In recent years, both grading[30] and dredging[31] have been held to be intangible costs subject to capitaliza-

27. 424 F.2d at 122. The estates involved are the working interest and the production payment interest. The oil in the ground is a capital asset in which the production payment owner has an incorporeal hereditament.

28. *Id.*

29. *Id. See also* C. BREEDING & A. BURTON, INCOME TAXATION OF OIL AND GAS PRODUCTION § 2.04 (1961).

30. Commonwealth Natural Gas Corp. v. United States, 395 F.2d 493, 494 (4th Cir. 1968).

31. Norfolk Shipbldg. & Drydock Corp. v. United States, 321 F. Supp. 222 (E.D. Va. 1971).

tion.[32] Capitalization of intangible expenses as additions to the estate has been specifically held to be proper by Revenue Ruling 72-403.[33] Decided in response to a request by another electric company, this ruling makes costs of acquiring easements for electrical transmission lines depreciable and initial grading a tangible asset.

Requiring capitalization as the result of a trade or business determination (as in *Southern Natural Gas*) is consistent with cases that have dealt with equipment depreciation which occurred prior to the commencement of business. In those cases involving extractive industries, such costs have been capitalized and recovered through deductions for depletion.[34] In *Idaho Power* the new assets had not been put into revenue-producing business at the time equipment depreciation was incurred. Thus, a portion of its business had not been commenced, and capitalization was appropriate so that costs could be matched against revenue which only arose later.

The taxpayer in *Idaho Power* did not rely wholly on a trade or business determination, however. It pointed to the words "paid out" in section 263[35] and contended that depreciation is not a payment and thus cannot be capitalized.[36] The court pursued interpretations of these words in other Code sections. Although depreciation has been held to be a "payment" for charitable contribution purposes,[37] it is not a "payment within the taxable year"[38] and is thus not deductible.

The Regulations themselves address the point obliquely. When otherwise ordinary and necessary business expenses are "paid *or incurred*"[39] to construct capital items, they themselves are capital items. To add to the confusion, the taxpayer in *Idaho Power* was sufficiently enamored of the paid-out notion to concede, contrary to its own in-

32. If the costs are "inextricably associated" with the land they may not be depreciated. Algernon Blair, Inc., 29 T.C. 1205, 1221 (1958).

33. 1972 INT. REV. BULL. No. 34, at 9-10.

34. Producers Chem. Co., 50 T.C. 940 (1968), *following* New Quincy Mining Co., 36 B.T.A. 376 (1937). The depreciation sustained prior to beginning active production, since not attributable to regular on-going business, was held capitalizable as a development cost to be recovered in deductions for depletion and was not a statutory net loss.

35. *See* note 2 *supra.*

36. 477 F.2d at 694.

37. Orr v. United States, 343 F.2d 553, 556 (5th Cir. 1965); *cf.* Rogers v. Commissioner, 281 F.2d 233 (4th Cir. 1960).

38. Maurice S. Gordon, 37 T.C. 986-87 (1962) (involving section 213, Medical Deductions). Note that section 213 requires capitalization of certain medical expenses to the extent they add value to the taxpayer's property.

39. Treas. Reg. § 1.263(a)-1(b) (1965) (emphasis added).

terests (and contrary to common accounting practice),[40] that even small tools paid for immediately, but which had lives of less than one year, should be capitalized in the year of purchase when used for capital construction.[41]

Although depreciation is not specifically included in the capitalization rule, it is not specifically exempted from the "no deduction" rule as are certain other provisions of the Code.[42] Nor is section 167 found among those sections singled out by the Regulations for taxpayers' election to deduct or capitalize.[43] By contrast, research and development expenses are allowable as an immediate deduction even if incurred in construction of capital assets.[44] The inescapable conclusion from the plain statutory words is that depreciation expense which meets the criteria of section 263 is required to be capitalized.

One of Idaho Power's major contentions was not argued until its appeal from the Tax Court. It asserted that deductions expressly set out in the Code are somehow different from ordinary business expenses (and thus not encompassed by section 263) simply by virtue of their specific treatment.[45] These special deductions include repairs (section 162), interest (section 163), taxes (section 164), research and experiment (section 174), and depreciation. The Tax Court in *All-Steel Equipment, Inc.*[46] supported this interpretation of the Code's overall scheme and cited several cases holding that "deductions expressly granted by statute are not to be deferred even though they relate to inventory or capital items."[47] However, this particular argument was rejected by the circuit court. The court said that under section 162 ordinary and necessary business repairs are not deductible immediately but only when the manufactured goods, related to the repairs, were sold.[48] The court of appeals held that the Tax Court erred

40. *See, e.g.*, G. WELSCH, C. ZLATKOVICH, & J. WHITE, INTERMEDIATE ACCOUNTING 470 (3d ed. 1972).

41. 39 P-H Tax Ct. Mem. at 430.

42. *See* INT. REV. CODE OF 1954, § 263(a)(1).

43. Treas. Reg. § 1.263(a)-3 (1965).

44. This is perhaps true because of the difficulties inherent in allocating the expenses to various projects. There is also a policy of encouraging research which stems from international technological competition.

45. The specific treatment is most likely due to the materiality and complexity of those various deductions.

46. 54 T.C. 1749 (1970), *rev'd*, 467 F.2d 1184 (7th Cir. 1972).

47. 54 T.C. at 1759.

48. All-Steel Equip., Inc. v. Commissioner, 467 F.2d 1184, 1186 (7th Cir. 1972). Seeming almost to foresee *Idaho Power*, the Tax Court had pointed out that the problem of cost allocation for capital assets is indistinguishable from allocation to inventory. 54 T.C. at 1759.

in concluding that special treatment of certain expenses in the Code dictates special timing too, and it required repairs to be allocated to inventory.[49]

Income tax Regulations also directly address this problem of which costs are properly a part of inventory. The Regulations require that in valuing inventory the taxpayer "shall conform as nearly as may be to the best accounting practice in the trade or business."[50] The American Institute of Certified Public Accountants, the recognized authority on accounting, advises that depreciation related to manufacturing is to be considered in the inventory computation.[51] It is appropriate under the Regulations for the taxpayer to allocate indirect costs (such as depreciation) to inventory for tax purposes in the same manner as he does on his books[52] when the inventory costs include the indirect costs necessarily incident to production.[53]

Finally, the court in *Northern Pacific Railway v. Helvering*,[54] a case factually similar to *Idaho Power*, stated that each unit of service as well as each unit of production must carry its proper proportion of all expenses.[55] This line of reasoning seems not only to justify but to require capitalization of construction depreciation even for service companies, so that expenses can properly be matched against revenue accruing from use of the asset constructed.

Section 446 of the Code requires that taxable income be computed by the same method of accounting as "book" income. Although the term "method of accounting" is broad in meaning, it does include the accounting treatment prescribed for depreciation.[56] Best tax and accounting treatment calls for clear presentation of income. This requires expenses to be matched against revenues by cause-and-effect or, failing that, by systematic rational allocation. Only if neither of these methods can be applied should expenses such as depreciation be simply charged off in periods in which incurred.[57]

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49. 467 F.2d at 1186. *See also* 1954 U.S. CODE CONG. & AD. NEWS 4851; *cf.* INT. REV. CODE OF 1954, § 174(b).

50. Treas. Reg. § 1.471-2(a)(1) (1958).

51. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING PRINCIPLES BOARD STATEMENT No. 4, ¶ 159 (1970); AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING TERMINOLOGY BULLETIN No. 4, ¶ 2 (1957).

52. Treas. Reg. § 1.446-1(c)(1)(i) (1970).

53. Treas. Reg. § 1.471-3(c) (1958).

54. 83 F.2d 508 (8th Cir. 1936).

55. *Id.* at 510. *But see* Rev. Rul. 141, 1953-2 CUM. BULL. 101.

56. Treas. Reg. § 1.446-1(a)(1) (1970).

57. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING PRINCIPLES BOARD STATEMENT No. 4, ¶ 161 (1970).

Immediate write-off of indirect production costs has an effect similar to accelerated depreciation methods: both postpone taxes. For growing utilities and other enterprises, this amounts to a permanent exemption. Nevertheless, accelerated depreciation allowances, additional first year depreciation, and investment tax credits are all evidence of the same congressional policy to allow current reduction of tax burdens by immediate deduction of construction depreciation.[58] The purpose of that policy is to free working capital in the economy for investment and thereby sufficiently raise aggregate taxable income in the long run so that no net tax revenue loss results for the government.[59]

Were *Idaho Power* to be followed generally in states which allow a "fair return" to utilities on the "fair value" of their assets, rates would undoubtedly be affected. Depreciation incurred in constructing electrical facilities is of considerable magnitude. If depreciation were to be capitalized the rate base would be inflated; if it is deducted immediately asset costs remain lower.[60] When depreciation is capitalized for rate purposes and deducted on tax returns, as in *Idaho Power*, rates become higher for present customers but more working capital is available for utility service expansion.

In its apparent adherence to congressional expansionary policy, the court in *Idaho Power* exercised liberality in construing the applicable statutes and regulations. Perhaps it realized that the usual narrow judicial scrutiny given deductions should not be invoked when private businesses perform what would otherwise entail public expense.[61]

Idaho Power, then, seems most readily justifiable as policy in action. It is contrary to expressed opinions of the I.R.S. and would surely have been resolved differently if the court had adhered to the plain meaning of the Code and Regulations. Indeed, reasoning by analogy from the Code would mandate a different result. For example, a contractor who constructs assets for others instead of himself and who uses the completed contract method of recognizing income is required to defer depreciation incurred during construction and to deduct it all in

58. 1954 U.S. CODE CONG. & AD. NEWS 4048: "For all segments of the American economy, liberalized depreciation policies should assist modernization and expansion of industrial capacity, with resulting economic growth, increased production, and a higher standard of living."

59. *Id.* at 4050.

60. In North Carolina, rates are computed by the Utilities Commission which considers, among other things, the original cost of property less accumulated depreciation. N.C. GEN. STAT. § 62-133(b)(1) (1965).

61. 1 J. MERTENS, *supra* note 11, § 3.07, at 17.

the year of completion.[62] This matches expense against revenue as required by sound accounting and tax principles. Proper matching in the *Idaho Power* situation would require *all* non-revenue producing costs incurred during construction to be deferred for later matching against revenue arising from use of the revenue producing capital asset itself.

CONCLUSION

The Court of Appeals for the Ninth Circuit seems to have attempted to justify a policy decision on non-policy grounds, with limited success. Even the implicit policy of economic expansion and investment, although applicable during the taxable years in question, is painfully passé in these days of inflation and congressional tightening of investment incentives. For its expressed rationale the court relied heavily upon the second *Great Northern* case, a discredited case which had been decided on a misunderstanding. The "trade or business" test applied is a section 167 rule that has been artifically grafted onto section 263 by several courts. It is a factual test, but its ill-defined application to the facts in *Idaho Power* affords little guidance to other taxpayers, even those residing in the Ninth Circuit. If Idaho Power's construction of its own power lines were not related to a business, no recovery of equipment cost should have been allowed at all.[63] If it were a regular business activity, then depreciation allowed should have been allocated against the revenue to be produced by the new assets, which were themselves most certainly used in the regular business.

The case was decided with a singular disregard for explicit rulings, sound cases, and statutory law. The record indicates that the Commissioner has consistently favored capitalization. The Internal Revenue Code states explicitly that provisions of Title 26 Part VI allowing deductions such as those in section 167 for depreciation are subject to Part IX exceptions, one of which is section 263.[64] It seems that "trade or business" can properly serve only as a threshold test for determining whether an item is of a depreciable nature. All consideration of capitalization must center in section 263 alone.

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62. Treas. Reg. § 1.451-3 (1957); 2 J. MERTENS, *supra* note 11, at § 12.130.

63. *Contra,* International Trading Co., 57 T.C. 455 (1971), *rev'd and remanded,* 484 F.2d 707 (1973). It was held that a corporation may deduct a loss realized on the sale of property which was neither used in the corporation's business nor held for the production of income.

64. INT. REV. CODE OF 1954, § 161.

Federal Tax Lien—Is It Effective Against a State Homestead Exemption?

Today most states have homestead exemptions that place a family residence beyond the reach of creditors' remedies.[1] Typically, these exemptions are valid against all but a limited class of debts.[2] In this era of the omnipresent tax collector, a recurring question has been whether the state homestead exemption is effective against the federal tax lien.[3] Since the nature and extent of the homestead exemption varies greatly from state to state,[4] a comprehensive answer to this problem is not available. A recent case, *United States v. Hershberger*,[5] represents one court's attempt to reconcile the competing interests of a state's homestead provisions and the federal government's desire for a uniform tax collection system.

Ralph and Esther Hershberger jointly owned real property, which they occupied as their residence, in Wichita, Kansas. In an attempt to satisfy a judgment against Ralph for over 28,000 dollars in unpaid taxes,[6] the United States sought to foreclose its tax lien against Ralph's interest in the property.[7] Esther claimed that her occupancy qualified

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1. The states not having homestead exemptions are Connecticut, Delaware, Indiana, Maryland, New Jersey, Pennsylvania, and Rhode Island. *See* S. RIESENFELD, CREDITORS' REMEDIES AND DEBTORS' PROTECTION 232-33 (1967).

2. These debts are generally of two types: (1) obligations incurred in acquiring and preserving the homestead and (2) obligations for taxes. *See generally* Haskins, *Homestead Exemptions*, 63 HARV. L. REV. 1289 (1950).

3. INT. REV. CODE OF 1954, § 6321 provides:

> If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

4. The exempted property may be described in monetary terms or acreage figures. Each state has its own requirements as to who may assert the exemption, when it can be claimed, and the type of property interest that is within its protection. *See* I AMERICAN LAW OF PROPERTY §§ 5.75-.84 (A.J. Casner ed. 1952).

5. 475 F.2d 677 (10th Cir. 1973).

6. Reducing a tax claim to judgment is not necessary for all tax collection efforts, but it tolls the six year statute of limitations on the federal tax lien indefinitely and is often advisable where there may be title or priority disputes. *See* W. PLUMB, FEDERAL TAX LIENS 49-51 (3d ed. 1972); Plumb, *Federal Tax Collection and Lien Problems*, 13 TAX L. REV. 247, 278-79 (1958).

7. INT. REV. CODE OF 1954, § 7403(a) provides:

> Filing.—In any case where there has been a refusal or neglect to pay any tax, or to discharge any liability in respect thereof, whether or not levy has been made, the Attorney General . . . may direct a civil action to be filed in a district court of the United States to enforce the lien . . . under this title with respect to such tax or liability or to subject any property, of what-

the residence as a homestead under Kansas law thus immunizing the property from seizure and sale.[8] The district court agreed and granted summary judgment for the Hershbergers.[9] On appeal, the Court of Appeals for the Tenth Circuit affirmed.[10] Following the reasoning of the district court, the circuit court held that the homestead exemption created an indivisible property interest in Esther that precluded the government from foreclosing the lien as long as she occupied the property as her residence.[11]

The federal tax lien is a major weapon in the government's tax collection arsenal. Arising automatically after a taxpayer refuses or neglects to comply with a tax assessment, the federal tax lien attaches to "all property or rights to property" belonging to the taxpayer.[12] Courts have generally followed the sweeping language of section 6321 and have upheld the lien's attachment to a broad range of property interests, including equitable and intangible interests, property normally exempt under federal and state laws, and after-acquired property the moment title passes to the taxpayer.[13]

Section 6321, however, creates no property rights but merely attaches federally defined rights to property interests created by state law.[14] Thus, initially, a court will look to state law to determine the nature and extent of a taxpayer's property rights.[15] If there is a suffi-

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ever nature, of the delinquent, or in which he has any right, title or interest, to the payment of such tax or liability.

8. KAN. CONST. art. 15, § 9 provides:

A homestead to the extent of one hundred and sixty acres of farming land, or of one acre within the limits of an incorporated town or city, occupied as a residence by the family of the owner, together with all the improvements on the same, shall be exempt from forced sale under any process of law, and shall not be alienated without the joint consent of husband and wife, when that relation exists; but no property shall be exempt from sale for taxes, or for the payment of obligations contracted for the purchase of said premises, or for the erection of improvements thereon. *Provided*, The provisions of this section shall not apply to any process of law obtained by virtue of a lien given by the consent of both husband and wife . . . .

The constitutional provisions are essentially reiterated in KAN. STAT. ANN. § 60-2301 (1964).

9. United States v. Hershberger, 338 F. Supp. 804 (D. Kan. 1972).

10. United States v. Hershberger, 475 F.2d 677 (10th Cir. 1973).

11. *Id.* at 682.

12. *See* note 3 *supra*. For an excellent practical discussion of the creation and timing of the lien see W. PLUMB, *supra* note 6, at 10-18.

13. This listing is by no means exhaustive but merely intended to indicate the reach of § 6321. For a general discussion of property subject to the lien *see* 9 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 54.52 (rev. ed. 1971).

14. *E.g.*, United States v. Bess, 357 U.S. 51, 55 (1958) (Int. Rev. Code of 1939, ch. 36, § 3670, 53 Stat. 448, is the predecessor to INT. REV. CODE OF 1954, § 6321 and the language of the two sections is virtually identical).

15. *E.g.*, Aquilino v. United States, 363 U.S. 509, 512-14 (1960).

cient property interest for the lien to attach, the court will then look to federal law to determine the lien's effectiveness against competing interests.[16] However, it is unclear whether the court must look to federal or state law to determine if the lien attaches to state property rights. The better conclusion would seem to be that federal law should determine the question of whether the lien attaches.[17]

The *Hershberger* court recognized the validity of the lien against Ralph's interest in the homestead,[18] but turned its attention to Kansas law to determine the rights of Esther in the family residence. The Kansas Constitution and the statute enacting the homestead provision specify that the home cannot be alienated without the joint consent of both husband and wife and is exempt from forced sale except for "sale for taxes, or for the payment of obligations contracted for the purchase of said premises, or for the erection of improvements thereon."[19] The court found no case on the issue of whether a homestead can be sold to pay for taxes not directly related to the family residence. Nevertheless, the district court had concluded that, since neither federal nor state income taxes had been adopted at the time the statute was enacted, the exception should be limited to property taxes on the home itself.[20] The circuit court accepted this reasoning[21] and concluded

16. *Id.*

17. Language can be found in Supreme Court opinions supporting either position. United States v. Bess, 357 U.S. 51, 55 (1958) (federal tax lien "attaches consequences, federally defined, to rights created under state law"). In Meyer v. United States, 375 U.S. 233 (1963), the Court explicitly relied on *Bess* but said, "once the tax lien has attached to the taxpayer's state created interests, we enter the province of federal law;" and "state law controls the determination of what is included within the [meaning of] 'property or rights to property.'" *Id.* at 236, 238. *See also* United States v. Durham Lumber Co., 363 U.S. 522, 526-27 (1960); Aquilino v. United States, 363 U.S. 509, 512-14 (1960). One student author concludes that the suggested meaning of *Bess* (federal law governs the attachment of the federal tax lien) was implicitly overruled by *Aquilino.* Note, 46 CORNELL L.Q. 624, 627 (1961). In a later treatment of this issue another commentator concludes otherwise. Comment, *Property Subject to the Federal Tax Lien,* 77 HARV. L. REV. 1485, 1485-87, 1490-91 (1964) (finds support for *Bess* in *Aquilino* and *Durham Lumber Co.*).

18. 475 F.2d at 679. It was stipulated in the district court that the lien attached to Ralph's undivided one-half interest in the homestead. 338 F. Supp. at 805. There is, however, language in the opinion of the court of appeals suggesting the opposite conclusion. "[Esther's] interest was separate and apart from her husband and therefore precluded the homestead from being part of the husband's estate." 475 F.2d at 682.

19. *See* note 8 *supra.*

20. 338 F. Supp. at 808. In most states the homestead is subject to a lien for taxes, while several permit the exemption to exclude only taxes on the homestead itself. *Compare* N.C. CONST. art. X, § 2(1), *and* ILL. ANN. STAT. ch. 52, § 3 (Smith-Hurd Cum. Supp. 1973), *with* OHIO REV. CODE ANN. § 2329.72 (Page 1953), *and* W. VA. CODE ANN. § 38-9-3 (1966).

21. 475 F.2d at 681.

that the homestead provision gave Esther a vested undivided one-half interest in the property.[22] The court was aided in its conclusion both by an early Kansas case that described a wife's interest in the homestead as an "estate"[23] and by other cases in which the Kansas Supreme Court had stated that the homestead provision was intended to create more than "a simple exemption statute" and was to be construed liberally.[24]

However, *Hershberger* cited no Kansas case holding that the homestead exemption created a "property right" in either spouse. The court rejected the argument that because a state court could divest either spouse of his or her homestead rights in a divorce action, the homestead "prior to divorce was not a vested property right."[25] Moreover, the court did not consider other Kansas law that described the interest in the homestead as a waivable benefit.[26] More to the point, the court's conclusion in this regard may have been unnecessary as the wife already possessed an undivided one-half interest in the home by virtue of her status as a joint tenant. The obvious suggestion is that the homestead exemption would give a spouse vested property rights in the homestead even if the other spouse held title as sole owner. Therefore, the key to the *Hershberger* opinion was not that the homestead exemption vested a property right, but that it created an indivisible interest in the property.

The real significance of this decision, though, lies in its holding that a federal tax lien against one spouse may not be enforced against his or her property rights in the homestead where the other spouse has an indivisible interest in the property. This means that state law not only defines what constitutes property rights within the language of section 6321, but also determines whether the federal government can enforce its lien against a delinquent taxpayer. It may be, as one authority suggests, that the "resolution of this issue may depend upon whether there is involved a single interest of the taxpayer who is subject to tax liability, or whether both spouses have an interest while only one is under a tax liability."[27]

The treatment accorded the federal tax lien by other courts in relation to state homestead exemptions offers little clarification. In

22. *Id.* at 682.
23. Helm v. Helm, 11 Kan. 19 (1873).
24. *E.g.*, West v. Grove, 139 Kan. 361, 31 P.2d 10 (1934).
25. 475 F.2d at 680.
26. *See* Schloss v. Unsell, 114 Kan. 69, 71, 216 P. 1091, 1092 (1923); *cf.* Cole v. Coons, 162 Kan. 624, 641, 178 P.2d 997, 1008 (1947) (concurring opinion).
27. 9 J. MERTENS, *supra* note 13, at 205.

only two other jurisdictions have courts held that a homestead exemption protects one spouse from levy or foreclosure for the tax debt of the other spouse.[28] In one of these jurisdictions, Texas, there is a conflict in the cases;[29] and in the other, Oklahoma, the precedential value of the cases is subject to serious doubt.[30] A number of courts have enforced a tax lien against one spouse's interest in the homestead property;[31] others have held the lien attachable to a single spouse's interest in the homestead property, but because of the nature of the action, make no mention of whether the lien could be enforced.[32] The only principles that seem free from doubt are that a lien will always attach to a taxpayer's interest in the homestead,[33] and a homestead is not exempt from seizure for the joint tax liability of both husband and wife.[34]

A brief look at other joint property interests recognized in various states and the susceptibility of these interests to the federal tax lien

28. Jones v. Kemp, 144 F.2d 478 (10th Cir. 1944) (Oklahoma); Morgan v. Moynahan, 86 F. Supp. 522 (S.D. Tex. 1949); Bigley v. Jones, 64 F. Supp. 389 (W.D. Okla. 1946); Paddock v. Siemoneit, 147 Tex. 571, 218 S.W.2d 428 (1949).

29. *Compare* Morgan v. Moynahan, 86 F. Supp. 522 (S.D. Tex. 1949), *and* Paddock v. Siemoneit, 147 Tex. 571, 218 S.W.2d 428 (1949), *with* United States v. Stone, 57-2 U.S. Tax Cas. ¶ 9864 (E.D. Tex. 1957), *and* Staley v. Vaughn, 50 S.W.2d 907 (Tex. Civ. App. 1932), *and* Staley v. Hopkins, 9 F.2d 976 (N.D. Tex. 1925).

30. The principal case, and the one relied on in *Hershberger*, is Jones v. Kemp, 144 F.2d 478 (10th Cir. 1944). The court in *Kemp* held that the Oklahoma homestead law did not create an "estate" in the wife but rather a "special and peculiar" interest, which prevents a tax lien against the husband from being enforced against the homestead. Nevertheless, the Oklahoma Supreme Court, on two different occasions has flatly stated that the Oklahoma homestead provision does not create any property rights in a spouse but merely a privilege of exemption from execution. Evans v. Evans, 301 P.2d 232, 234 (Okla. 1956); Mercer v. McKeel, 188 Okla. 280, 284, 108 P.2d 138, 141 (1940). As recognized by the *Hershberger* court itself, 475 F.2d at 682, state homestead laws conferring privileges and exemptions are subordinate to the federal tax lien. Shaw v. United States, 331 F.2d 493 (9th Cir. 1964); Weitzner v. United States, 309 F.2d 45 (5th Cir. 1962), *cert. denied*, 372 U.S. 913 (1963). Furthermore, the *Kemp* court held that Mrs. Kemp was not the lawful wife of Mr. Kemp at the time the tax lien attached and thus could not assert homestead rights. 144 F.2d at 481. The only other decision, Bigley v. Jones, 64 F. Supp. 389 (W.D. Okla. 1946), directly relied on *Kemp*.

31. *E.g.*, Weitzner v. United States, 309 F.2d 45 (5th Cir. 1962), *cert. denied*, 372 U.S. 913 (1963); United States v. Heffron, 158 F.2d 657 (9th Cir.), *cert. denied*, 331 U.S. 831 (1947); United States v. Olgeirson, 284 F. Supp. 655 (D.N.D. 1968); United States v. Tressler, 66-1 U.S. Tax Cas. ¶ 9228 (S.D. Cal. 1966); United States v. Heasley, 170 F. Supp. 738 (D.N.D.), *aff'd*, 272 F.2d 947 (8th Cir. 1959); Bedami v. Tomlinson, 48 Am. Fed. Tax R. 1471 (S.D. Fla. 1954).

32. *E.g.*, Carter v. United States *ex rel.* D.I.R., 399 F.2d 340 (5th Cir. 1968); Shaw v. United States, 331 F.2d 493 (9th Cir. 1964); Aronow v. United States, 65-2 U.S. Tax Cas. ¶ 9692 (D. Mont. 1965); Jamison v. Geers, 35-1 U.S. Tax Cas. ¶ 9319 (W.D. Okla. 1935).

33. *E.g.*, Shambaugh v. Scofield, 132 F.2d 345 (5th Cir. 1942); United States v. Howard, 296 F. Supp. 264 (D. Ore. 1968); Birch v. Dodt, 2 Ariz. App. 228, 407 P.2d 417 (1965).

34. *E.g.*, United States v. Estes, 450 F.2d 62 (5th Cir. 1971).

proves useful. Tenancy by the entirety, peculiar to the husband and wife relationship and recognized in twenty-one states,[35] has proved particularly troublesome to the federal tax collector. Since legal title is vested in the fictional unity of marriage, neither spouse, nor his or her creditors, can force a partition.[36] A substantial minority of states recognizing tenancy by the entirety, however, permit creditors of one spouse to reach a half-interest in the estate, subject to the other spouse's rights.[37] In these states, the tax lien provides the federal government with the same rights as ordinary creditors. But in the majority of the states, the government is not only denied the right to levy upon or foreclose an entirety interest, but is also denied the protection of the lien.[38]

The federal tax collector has fared better against the taxpayer's interests in joint tenancies and community property. In the case of joint tenancies, the government may enforce its claim against the delinquent taxpayer's interest by a sale of the whole property even though there are third parties whose interests are not subject to the lien.[39] Since the government's rights under the lien are no greater than those of the tax-

35. *See generally* 4A R. POWELL, THE LAW OF REAL PROPERTY ¶ 622-23 (1967).

36. *Id.* at ¶ 623; Annot., 75 A.L.R.2d 1172 (1961); Annot., 166 A.L.R. 969 (1947).

37. *See* note 36 *supra.*

38. *See* Benson v. United States, 442 F.2d 1221 (D.C. Cir. 1971); Cole v. Cardozo, 441 F.2d 1337 (6th Cir. 1971); United States v. American Nat'l Bank, 255 F.2d 504 (5th Cir.), *cert. denied*, 358 U.S. 835 (1958); Raffaele v. Granger, 196 F.2d 620 (3d Cir. 1952); United States v. Hutcheson, 188 F.2d 326 (8th Cir. 1951). This rule also extends to rents and profits derived from entirety property. *See* Moore v. Glotzbach, 188 F. Supp. 267 (E.D. Va. 1960). *Contra*, Pilip v. United States, 186 F. Supp. 397 (D. Alas. 1960).

Tenancies by the entirety have been harshly criticized as creating "a privileged sanctuary from the collection of federal taxes, a fictional bicephalous non-tax-paying personality which is permitted to accumulate wealth free of the citizenship obligations of either of the individuals who comprise the unit and for whose exclusive benefit it exists." Plumb, *Federal Liens and Priorities—Agenda for the Next Decade II*, 77 YALE L.J. 605, 636 (1968). For a more favorable view of entirety interests see Comment, *Federal Lien Provisions and State Law: The Problem of Giving Effect to Both in the Area of Joint Property Ownership*, 25 SW. L.J. 456, 465 (1971).

In 1954 the House of Representatives made an effort to specifically include entirety interests within the scope of § 6321, but the Senate rejected the effort because it was "not clear what change in existing law would be made" by doing so. *See* H.R. 1337, 83d Cong., 2d Sess. 406 (1954); S. 1622, 83d Cong., 2d Sess. 575 (1954).

39. United States v. Kocher, 468 F.2d 503 (2d Cir. 1972), *cert. denied*, 411 U.S. 931 (1973); United States v. Trilling, 328 F.2d 699 (7th Cir. 1964); United States v. Mosolowitz, 269 F. Supp. 12 (D. Conn. 1967); United States v. Anderson, 66-2 U.S. Tax Cas. ¶ 9646 (D.S.C. 1966); *accord*, Washington v. United States, 402 F.2d 3 (4th Cir. 1968). *Contra*, Folsom v. United States, 306 F.2d 361 (5th Cir. 1962). Later cases in other circuits have rejected *Folsom* as misconstruing the language of section 7403. United States v. Kocher, *supra*; United States v. Trilling, *supra*. Additionally, there are other factors that suggest the case may be distinguishable on its facts. *See* Comment, 25 SW. L.J., *supra* note 38, at 466.

payer,[40] the other joint tenants are protected to the extent that they receive their full share of the sale proceeds.[41] Community property is treated similarly. Even though each spouse is considered to have a vested undivided interest in the community, the property is subject to sale to satisfy a lien against only one of them.[42] Thus, in those cases where a delinquent taxpayer has a vested undivided interest in jointly owned property, the tax lien can be enforced, regardless of the fact that another person may have an equal or similar interest in the same property. The one exception appears to be in those states that do not subject tenancies by the entirety to creditor's claims.[43] There the lien is ineffective, not because state law prohibits enforcement, but because a taxpayer does not have a separate property interest to which the lien can attach.[44]

Under this reasoning, Esther's vested undivided interest in the homestead should not have been an obstacle to enforcement of the lien. Similarly, characterization of that interest as an indivisible property right should not have barred the efforts of the federal government to reach legitimate property interests of the defaulting taxpayer. In *United States v. Overman*,[45] the argument was advanced that a Washington law that exempted community property from a husband's premarital debts was a rule of property law limiting "the extent and quality of his ownership rights" in the community.[46] Therefore, the defendant taxpayer contended that the tax lien could not be enforced against the husband's rights in the property. But even assuming the characterization of the Washington law as a property qualification was correct, the court said, "all that section 6321 requires is that the interest be 'property' or 'rights to property.' It is of no statutory moment how extensive may be those rights under state law, or what restrictions exist on enjoyment of those rights."[47]

Clearly "[t]he attachment of a tax lien under section 6321 and the enforcement of the lien under section 7403 . . . present different

40. *See, e.g.*, 9 J. MERTENS, *supra* note 13, at 192-93.

41. *See, e.g.*, United States v. Mosolowitz, 269 F. Supp. 12 (D. Conn. 1967).

42. *E.g.*, Broday v. United States, 455 F.2d 1097 (5th Cir. 1972); *In re* Ackerman, 424 F.2d 1148 (9th Cir. 1970); United States v. Overman, 424 F.2d 1142 (9th Cir. 1970); *cf.* United States v. Mitchell, 403 U.S. 190 (1971).

43. *See* notes 35-36 *supra*.

44. *E.g.*, United States v. Hutcheson, 188 F.2d 326 (8th Cir. 1951) (husband's interest in a tenancy by the entirety "like the rainbow in the sky or the morning fog rising from the valley").

45. 424 F.2d 1142 (9th Cir. 1970).

46. *Id.* at 1145.

47. *Id.*

questions."[48] But once the lien attaches, the enforcement is purely a federal question.[49] The only property that is exempt from seizure for a tax debt is that immune from levy under section 6334(a).[50] The obvious problem with allowing state homestead exemptions to extend the minimal protection of Section 6334(a) is the inequities it would create among delinquent taxpayers. The Internal Revenue Code is designed to tax persons in equivalent positions equally. It would seem only fair to subject equally situated individuals to the same liabilities when they fail to pay their taxes. To do otherwise would mean that, depending on how each state characterizes its homestead exemption, one taxpayer's residence would be safe from the federal tax lien while another's would be vulnerable.

This disparity would be further aggravated by the maximum exemptions in each state. They range from nothing in those states that do not have homestead provisions to 20,000 dollars in California.[51] Where the exemption is described in acreage rather than monetary terms, one taxpayer may be immunized to the extent of a modest bungalo while a neighbor's exemption could run into the hundreds of thousands of dollars. It may be argued that this is the result in those states that recognize and exempt tenancy by the entirety. But tenancy by the entirety is a common law property interest with deep roots in our Anglo-American heritage. Homestead exemptions, on the other hand, regardless of whether construed as vesting property rights, are constitutional and/or statutory overlays that can attach to almost any type of property interest.

Denying a taxpayer the protection of homestead exemptions when the government seeks to collect its tax dues may seem unnecessarily harsh. It is, however, no different than the treatment accorded other exemption laws designed to protect the impecunious. In bankruptcy, where state exemption laws are normally given effect,[52] the federal lien can be enforced against property set aside for the bankrupt.[53] Disability insurance benefits under the Social Security Act,[54] alimony payments[55]

48. *Id.*

49. United States v. Bess, 357 U.S. 51 (1958).

50. INT. REV. CODE OF 1954, § 6334(a). For a discussion of the limited nature of the exemption, *see* 9 J. MERTENS, note 13 *supra*, at § 49.192.

51. CAL. CIV. CODE § 1260 (West Supp. 1973).

52. Bankruptcy Act § 6, 11 U.S.C. § 24 (1970).

53. United States v. Heffron, 158 F.2d 657 (9th Cir.), *cert. denied*, 331 U.S. 831 (1947).

54. Kane v. Burlington Savings Bank, 320 F.2d 545 (2d Cir. 1963).

55. Rev. Rul. 89, 1953-1 CUM. BULL. 474; Campbell v. Campbell, 88 N.J. Super. 63, 210 A.2d 644 (1965).

and wages and salaries without a minimum for subsistence are[56] all subject to seizure.

The federal tax lien is wholly a federal creature and "matters directly affecting the nature or operation of [the lien] are federal questions, regardless of whether the federal statutory scheme specifically deals with them or not."[57] The language of the statute specifies that there shall be a lien on "all property or rights to property" without exception.[58] If state law were to govern the attachment, a state could place recognized property rights beyond the reach of the federal lien and, thus, produce undesirable vagaries in the federal tax collection effort. The underlying policy of federal taxation is to insure as much uniformity as possible.[59] By permitting federal law to govern, courts would be able "to subject to the lien the wide range of property interests commanded by the sweeping language of the statute, as well as to exclude some interests as not being within the statutory purpose."[60]

In recent years, Congress has shown a tendancy to expand the category of property exempt under section 6334(a).[61] Hopefully, it will recognize the need for uniformity with respect to protection of the homestead and expand section 6334(a) to include provisions similar to the more progressive state homestead exemptions.

STUART T. WILLIAMS

Liability Insurance—The Movable Link Between Coverage Denial and Settlement Offers

Insurance litigation has produced uncertainty about a carrier's obligations when its insured has caused damages beyond policy limits; the insurer denies coverage to its insured because it believes, in good

56. Antrum v. United States, 127 F. Supp. 54 (D. Conn. 1953).

57. United States v. Brosnan, 363 U.S. 237, 240 (1960). The Court, however, recognized that when "Congress resorted to the use of liens, it came into an area of complex property relationships long since settled and regulated by state law." Thus the Court felt that in regards to divestiture of federal tax liens, where there existed well-established state procedures, state law should be adopted as a matter of federal policy. *Id.* at 241-42. *But see* Comment, 25 SW. L.J., *supra* note 38, at 460 n.43.

58. INT. REV. CODE OF 1954, § 6321, *quoted in* note 3 *supra.*

59. *E.g.*, United States v. Gilbert Associates, Inc., 345 U.S. 361 (1953); Burnet v. Hamel, 287 U.S. 103, 110 (1932).

60. Comment, 77 HARV. L. REV., *supra* note 17, at 1503.

61. *See* 9 J. MERTENS, *supra* note 13, at § 49.192.

faith, that the policy does not apply; and the injured party then offers settlement.[1] At least one jurisdiction[2] has held that the insurance company must either accept "reasonable settlement offers,"[3] despite grounds for disclaiming coverage, or face liability in excess of policy limits if a subsequent suit determines that coverage exists.[4] Confusion has arisen because other jurisdictions, although purportingly rejecting this strictly liable rule, still impose excess liability on companies that have rejected settlement following a good faith denial of coverage. The purpose of this note is to show how courts are reaching this excess liability result and to suggest measures insurers can take to avoid it.

The dangers of excess liability in connection with coverage denial and settlement refusal were demonstrated in *Luke v. American Family Mutual Insurance Co.*[5] American issued a 50,000 dollar automobile accident policy. The insured, intoxicated and driving on the wrong side of the road, collided with the plaintiffs' car, killing one person and injuring two. American did not dispute the material facts of the accident, but its thorough investigation disclosed a coverage exclusion de-

1. This note is concerned with the following series of events: (1) the insured is clearly at fault in causing an accident which results in damages in excess of policy limits; (2) the insurance company denies coverage and refuses to defend because it believes in good faith that the claim is outside the scope of the policy or that the insured has failed to comply with policy terms; (3) the injured party sues the insured but before final judgment offers the insurance carrier settlement within policy limits; (4) the insurer declines settlement; (5) the injured party obtains judgment against the insured in excess of policy limits; (6) the insured assigns all his rights under his policy to the injured party; (7) the injured party sues the insurance company on the policy; (8) the court, determining that the company exercised good faith in denying coverage but erred, holds the insurer liable under the policy. The issue is whether the company's liability extends beyond the policy limit and, if so, upon what basis.

2. Comunale v. Traders & Gen. Ins. Co., 50 Cal. 2d 654, 328 P.2d 198 (1958).

3. "Reasonable settlement offers" means offers by the injured party to settle within policy limits, especially "[w]hen there is great risk of a recovery beyond the policy limits so that the most reasonable manner of disposing of the claim is a settlement which can be made within those limits . . . ." *Id.* at 659, 328 P.2d at 201.

4. Even though *Comunale* refers to "wrongful" denial of coverage, it makes clear that "[t]he decisive factor in fixing the extent of . . . liability . . . is the refusal to accept an offer of settlement within the policy limits." *Id. Comunale* asserts a strict liability rule based upon "the implied obligation of good faith and fair dealing [which] requires the insurer to settle in an appropriate case although the express terms of the policy do not impose such a duty." *Id.* For varied analyses of *Comunale, see* Note, *Insurance: Duty of Liability Insurer to Accept Offer of Settlement Within Policy Limits,* 10 HASTINGS L.J. 198 (1958); 47 GEO. L.J. 601 (1959); 57 MICH. L. REV. 775 (1959); 107 U. PA. L. REV. 571 (1959).

5. 325 F. Supp. 1330 (D.S.D. 1971) (mem.), *aff'd in part and rev'd in part,* 476 F.2d 1015 (8th Cir. 1973), *aff'd on other grounds on rehearing en banc, id.* at 1023, *rehearings denied, id.* at 1015.

fense upon which it relied to deny coverage.[6] The injured parties sued the insured in a tort action in which American took no part.[7] Before obtaining judgments, the plaintiffs offered to settle with American for 49,000 dollars, but American refused.[8] Since the state courts had not interpreted the exclusion American was asserting, the plaintiffs offered to hold their suit in abeyance until American could file a declaratory action to determine whether coverage obtained.[9] When American failed to seek a declaratory judgment, the plaintiffs proceeded with their suit against the insured in the South Dakota court. The plaintiffs received over 138,000 dollars in judgments and obtained from the insured an assignment of his rights against American.[10]

The district court permitted recovery against the company but only to the limits of the policy.[11] Cross appeals went to the Eighth Circuit Court of Appeals where a three judge panel approved the "strict liability" rule of *Comunale v. Traders & General Insurance Co.*[12] and imposed liability on American for the entire judgment returned against its insured.[13] On rehearing en banc, a sharply divided court affirmed.[14] The three judges who heard the initial appeal adopted

6. 476 F.2d at 1017-18. The insured never applied for coverage of the accident vehicle. He relied upon a thirty day automatic coverage clause for newly acquired automobiles, which applied only if at the time of the accident American had insured "*all* private passenger and utility automobiles *owned by the named insured on the day of its acquisition.*" *Id.* at 1017 (emphasis by the court). The insurance company argued that on the day the insured acquired the accident vehicle he legally owned a 1959 Oldsmobile, which he had driven for three months without insurance before it became disabled with engine trouble. Coverage turned upon the district court's finding "that the 1959 Oldsmobile was not an automobile owned by the named insured within the meaning of the 'automatic insurance' provisions of the policy . . . ." 325 F. Supp. at 1333, *aff'd*, 476 F.2d at 1017.

7. 325 F. Supp. at 1331; 476 F.2d at 1017.

8. 476 F.2d at 1020.

9. *Id.*

10. *Id.* at 1017.

11. 325 F. Supp. at 1334. In limiting liability to policy limits, the court reasoned from Kunkel v. United Security Ins. Co., 84 S.D. 116, 168 N.W.2d 723 (1969), that liability for damages in excess of policy limits would be conditioned by the South Dakota Supreme Court "upon a finding that the insurer had exercised bad faith in rejecting the settlement offer" *and* "upon a finding that the insurer exercised bad faith in reaching its decision not to defend." 325 F. Supp. at 1333-34. *Kunkel* involved an insurer who had undertaken the defense, thus it is factually distinguishable from *Luke*; nevertheless, *Kunkel* is the authority relied upon in both the district court and court of appeals opinions. The better interpretation of *Kunkel* seems to be that, given the court's emphasis on the jury's determining bad faith from the totality of circumstances, it does not foreclose the possibility of finding bad faith for refusing to settle when preceded by a good faith denial of coverage. This is the dissent's conclusion in *Luke*. 476 F.2d at 1026-27.

12. 50 Cal. 2d 654, 328 P.2d 198 (1958); *see* note 4 *supra*.

13. 476 F.2d at 1022.

14. *Id.* at 1023.

their previous opinion, but the three judges concurring in the result agreed with the three dissenters that the company's excess liability for refusing to settle should be based upon bad faith in not giving equal consideration to the insured's interests. Although the dissent urged that the issue of bad faith was for the jury, the concurring judges found American "guilty of bad faith in refusing to settle as a matter of law."[15]

Luke raises two major questions. The first is the method the concurring judges used to find American guilty of bad faith as a matter of law when, by all accounts, the company had investigated the facts, researched the available law, and interpreted its exclusion claim in a "not unreasonable" way in deciding to deny coverage.[16] The second is the means, short of settlement, American could have employed to protect itself from excess liability. The answers involve the manipulation of the link between a good faith denial of coverage and the duty to settle.

The typical automobile liability policy provides that the insurer "shall defend . . . any suit against the insured . . . even if such suit is groundless, false or fraudulent . . . ."[17] This standard defense clause clearly imposes a duty to defend, which the company must discharge with due care or be subject to liability for damages in excess of the policy's coverage.[18] With some exceptions, the words "groundless, false, or fraudulent" refer to suits instituted against the insured stating allegations which, if true, would come within the scope of policy coverage. Accordingly, a claim outside policy coverage or the insured's noncompliance with the express conditions in the policy normally per-

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15. *Id.*

16. In finding American had not acted in bad faith as a matter of law by denying coverage and refusing settlement, the district court cited American's diligence in investigating the facts and interpreting the law. 325 F. Supp. at 1334. In rejecting plaintiffs' claim for attorneys' fees, the panel on first appeal incorporated the lower court's review of American's good faith in denying coverage and found that American's refusal to pay the plaintiffs as assignees of the insured was neither "vexatious" nor "without reasonable cause." 476 F.2d at 1022-23. None of the judges on rehearing en banc challenged American's good faith in refusing to defend and denying coverage.

17. 4 W. FREEDMAN, RICHARDS ON THE LAW OF INSURANCE 2043 (5th ed. 1952); R. KEETON, BASIC TEXT ON INSURANCE LAW 658 (1971).

18. R. KEETON, *supra* note 17, at § 7.6(b). *Compare* Grain Dealers Mut. Ins. Co. v. Hardware Dealers Mut. Fire Ins. Co., 196 So. 2d 650 (La. Ct. App. 1967) (duty to defend is contractual), *with* City of Peoria v. Underwriter's at Lloyd's London, Uninc., 290 F. Supp. 890, 892 (S.D. Ill. 1968) (if the contract "provides that insurers may, 'if they so desire,' 'take over the conduct . . . of the defense of any claim,'" then a mere right to defend is created and not an obligation). For a discussion of pitfalls for the insured as well as insurer concerning the duty to defend, *see* Comment, *The Insurer's Duty to Defend Under a Liability Insurance Policy*, 114 U. PA. L. REV. 734 (1966).

mits the company to deny coverage and may remove the duty to defend.[19] Because courts interpret coverage exclusions "equitably" instead of "functionally," however, insurance carriers are seldom confident their exclusion defenses will succeed.[20] Even so, as long as the carrier denies coverage in good faith, losing the exclusion argument ordinarily results in liability limited to the amount of the policy plus the insured's attorneys' fees and court costs.[21]

The standard defense clause also states the responsibilities of the insurer regarding settlement: " . . . the company shall have the right to make such investigation, negotiation and settlement of any claim or suit as may be deemed expedient by the company . . . ."[22] Although this language indicates insurer discretion, courts have consistently held carriers to a duty to settle within policy limits because of the insurer's exclusive control of the litigation and its fiduciary relationship with the insured.[23]

Even though an insurer has denied coverage, claimants regularly offer to settle. Since few insureds can satisfy a substantial adverse judgment, the plaintiff approaches the company in hopes of receiving some payment. Although settling within policy limits might spare the carrier extra expenses if its coverage exclusion defense fails and liability is imposed up to policy limits, the company's interests normally dictate refusing settlement. Most offers are barely within policy limits; moreover, the insurer's exclusion defense may be upheld, absolving the company of any liability. The insured, on the other hand, always advocates compromise to avoid litigation and possible personal liability for damages awarded beyond policy limits. The claimant usually has nothing to lose by forcing the interests of the insurer and the insured plainly into conflict. If the company settles, the plaintiff frequently gets more than he could realize from the insured. If the com-

19. 7A J. APPLEMAN, INSURANCE LAW AND PRACTICE § 4683 (1962) states the majority rule: "An insurer's duty to defend an action against the insured is measured, in the first instance, by allegations in the plaintiff's pleadings, and if such pleadings state facts bringing the injury within the coverage of the policy, the insurer must defend . . . ." For modifications of this rule, in which the duty to defend remains despite claims being outside the scope of the insurance contract, *see* R. KEETON, *supra* note 17, at § 7.6(a).

20. *See* E. PATTERSON, ESSENTIALS OF INSURANCE LAW § 67 (2d ed. 1957).

21. Mannheimer Bros. v. Kansas Cas. & Sur. Co., 149 Minn. 482, 184 N.W. 189 (1921), *cited by* Comunale v. Traders & Gen. Ins. Co., 50 Cal. 2d 654, 659, 328 P.2d 198, 201 (1958).

22. *See* authorities cited note 17 *supra.*

23. Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136, 1138 (1954).

pany refuses, he has laid the foundation for an excess damages verdict against it.

Two factors coalesce in determining whether the insurer breaches its duty to settle: (1) the basis for imposing liability and (2) the relative consideration the carrier must give the insured's interests.[24] The basis for liability may be bad faith[25] (the test adopted by the majority of jurisdictions), negligence,[26] or some variant.[27] Alternatives under the relative consideration factor include the company's giving either "paramount consideration to the insured's interests,"[28] or "at least equal consideration to the insured's interests,"[29] or "paramount consideration to its own interests."[30] Nearly all courts adopt the "at least equal consideration" test so that the prevailing standard used to judge the insurer's compliance with its duty to settle is that the carrier must exercise good faith in giving equal consideration to the insured's interests.[31]

The "relative consideration" alternatives of the duty to settle are

24. Keeton, *Ancillary Rights of the Insured Against His Liability Insurer*, 13 VAND. L. REV. 837, 839-42 (1960). *See also* R. KEETON, *supra* note 17, at § 7.8(b).

25. *E.g.*, Kohlstedt v. Farm Bureau Mut. Ins. Co., 258 Iowa 337, 139 N.W.2d 184 (1965); Georgia Cas. Co. v. Mann, 242 Ky. 447, 46 S.W.2d 777 (1932); Wynnewood Lumber Co. v. Travelers Ins. Co., 173 N.C. 269, 91 S.E. 946 (1917).

26. *E.g.*, Dumas v. Hartford Accident & Indem. Co., 94 N.H. 484, 56 A.2d 57 (1947); G.A. Stowers Furniture Co. v. American Indem. Co., 15 S.W.2d 544 (Tex. Comm'n App. 1929); *cf.* Gedeon v. State Farm Mut. Auto. Ins. Co., 410 Pa. 55, 188 A.2d 320 (1963).

27. *See* Keeton, *supra* note 23, at 1139-48. Concerning stricter standards, *see* Crisci v. Security Ins. Co., 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

28. Tyger River Pine Co. v. Maryland Cas. Co., 170 S.C. 286, 170 S.E. 346 (1933); *cf.* National Mut. Cas. Co. v. Britt, 203 Okla. 175, 200 P.2d 407 (majority opinion), 218 P.2d 1039 (dissenting opinion) (1948).

29. *E.g.*, Comunale v. Traders & Gen. Ins. Co., 50 Cal. 2d 654, 328 P.2d 198 (1958); Kunkel v. United Security Ins. Co., 84 S.D. 116, 168 N.W.2d 723 (1969).

30. Wisconsin Zinc Co. v. Fidelity & Deposit Co., 162 Wis. 39, 155 N.W. 1081 (1916); *cf.* Hilker v. Western Auto. Ins. Co., 204 Wis. 1, 231 N.W. 257 (1930), *aff'd on rehearing*, 204 Wis. 12, 235 N.W. 413 (1931).

31. In cases where the company has acknowledged coverage, the "good faith-equal consideration" test has been translated into more workable terms: "[w]ith respect to the decision whether to settle or try the case, the insurance company must in good faith view the situation as it would if there were no policy limit applicable to the claim." Keeton, *supra* note 24, at 841. Although this characterization gives "equal consideration" more concreteness, the problem of explaining "good faith" remains, prompting one judge to complain that "enunciation of the rule is not difficult but its application is troublesome." Farmers Ins. Exch. v. Henderson, 82 Ariz. 335, 339, 313 P.2d 404, 406 (1957). Whatever value this working formula has in determining the duty to settle when the insurer defends, it dissipates when the insurer denies coverage and refuses to defend, since policy limits would not affect a decision based on absence of liability altogether. It is this circumstance—a refusal to settle following a good faith denial of coverage—which makes application of the "good faith-equal consideration" standard most difficult and which provides the setting for *Luke*.

particularly important since selecting either extreme carries significant consequences. Adherence to the "paramount consideration of the insurer's interests" standard allows the insurer to resist settlement with impunity since its interests are against settling. The opposite extreme—"paramount consideration of the insured's interests"—means always having to settle and "compel[s] the conclusion . . . that the company is strictly liable for the excess if it refuses a settlement offer within policy limits."[32] Because of these "strictly innocent" or "strictly liable" results, the middle formula of equal consideration is by far the prevailing view.

Since the exclusion defenses leading to denying coverage apply with equal force when settlement is offered, some authority supports the proposition that a good-faith-though-mistaken denial of coverage satisfies the "good faith-equal consideration" standard of the duty to settle.[33] Emphasizing that insurers need only *consider* not *act* upon the insured's interests, many courts have decided that refusal to settle based upon a good faith denial of coverage does not extend the company's liability beyond policy limits.[34] However, despite an insurer's good faith denial before rejecting settlement, other courts, also asserting the "good faith-equal consideration" test, have held the carrier liable for the entire judgment rendered against the insured.[35] *Luke* helps explain these inconsistent rulings by exposing how courts can manipulate the link between coverage denial and settlement refusal to shift the relative consideration standard from "strictly innocent" to "strictly liable" under the guise of equal consideration. The dissent, in particular, reveals the key to how this shifting technique operates.

Judge Bright, concurring on the finding of American's coverage but dissenting on the issue of excess liability, identifies three rules used

32. Keeton, *supra* note 23, at 1145.

33. *See* text accompanying note 37 *infra*. North Carolina adheres to the rule whereby "an insurer may not be held liable for an honest mistake in judgment, even if unreasonable," in effecting settlement. Abernethy v. Utica Mut. Ins. Co., 373 F.2d 565, 568 (4th Cir. 1967) (applying North Carolina law). The requirements for liability in North Carolina frequently appear in tandem—acting with wrongful or fraudulent purpose or with lack of good faith—suggesting that something at least akin to fraud is necessary to establish bad faith. *See* Wynnewood Lumber Co. v. Travelers Ins. Co., 173 N.C. 269, 91 S.E. 946 (1917). Accordingly, the insurer's good faith belief that coverage does not exist should present a strong argument against showing the company acted with bad faith in refusing settlement.

34. "Undoubtedly this is an attempt to relieve the insurer from the seemingly illogical position of having to effect a final settlement when reasonable investigation indicated no liability on its part for the claim." 57 MICH. L. REV. 775, 776 (1959).

35. Comunale v. Traders & Gen. Ins. Co., 50 Cal. 2d 654, 328 P.2d 198 (1958); Landie v. Century Indem. Co., 390 S.W.2d 558 (Kansas City, Mo., Ct. App. 1965).

to relate an insurer's good faith denial of coverage to its refusal to settle: the "insulation" rule, the "strict liability" rule, and the "middle" rule.[36]

The dominant feature of the "insulation" rule is the recognition of a close nexus between a good faith coverage denial and the settlement refusal. In approving this rule, courts—including the district court in *Luke*—have reasoned that since the same factor, *i.e.* a coverage exclusion defense, has overriding effect on both the decision to deny coverage and the decision to refuse settlement, a finding of good faith as to the former necessitates finding good faith and equal consideration as to the latter.[37] Denying coverage in good faith "insulates" the company from excess liability for resisting settlement. The result is the same as the "paramount consideration of the insurer's interests" extreme, even though the court proclaims earnest adherence to the "good faith-equal consideration" test. Once the company finds a defensible reason for denying coverage, it can reject settlement attempts without risking excess liability.

The "middle" view best preserves the literal meaning of the "good faith-equal consideration" standard.[38] This rule appreciates the connection between a good faith coverage denial and refusal to settle but does not preclude a finding of bad faith regarding settlement. Although good faith in denying coverage works in the insurer's favor, it is merely "one of the factors" for the trier of fact in determining bad faith on the settlement question.[39] Under this view, the insurer should at

36. 476 F.2d at 1025.

37. Of the cases cited by Judge Bright in support of the "insulation rule," only the district court opinion and State Farm Mut. Auto. Ins. Co. v. Skaggs, 251 F.2d 356 (10th Cir. 1957) seem to preclude a finding of bad faith in refusing to settle once a good faith denial of coverage has been established. Taken together, the cases under the "insulation" heading advocate a view whereby a good faith coverage denial creates a rebuttable presumption that the company exercised good faith in refusing to settle. While the practical consequences may be tantamount to "insulation," a better heading for the category would focus on the presumptive, rather than insulating effects. In the interest of clarity, however, the text adopts Judge Bright's characterization.

38. By including Western Cas. & Sur. Co. v. Herman, 405 F.2d 121 (8th Cir. 1968) in the "middle" view, Judge Bright misconceives the consequences each category has on the relationship between a good faith denial of coverage and the refusal to settle. Judge Bright joined in the Herman opinion which upheld the proposition that a "good faith belief that coverage existed constitutes no excuse for its failure to settle." *Id.* at 122. Furthermore, the court of appeals quotes approvingly from the court below: "The defendant gambled on the question of policy coverage and lost. They [sic] are required to pay the consequences." *Id.* As a result *Herman* properly belongs with the strict liability cases. *See* text accompanying notes 41-44 *infra.*

39. Kunkel v. United Security Ins. Co., 84 S.D. 116, 122-23, 168 N.W.2d 723, 726-27 (1969).

least steadfastly review the situation whenever confronted with a settlement offer after having denied coverage.

Kunkel v. United Security Insurance Co., the decision relied upon by the concurring opinion, clearly incorporates into its "good faith-equal consideration" standard the evidentiary relationship envisioned by the "middle" view.[40] In applying *Kunkel*, however, the concurring judges in *Luke* only adopted the traditional two-step criteria of good faith and equal consideration and ignored *Kunkel's* approval of the evidentiary connection between a good faith denial of coverage and the issue of bad faith in exercising the duty to settle. The concurring opinion leaves no room for interpretation:

> The effect of this holding is that an insurer who breaches its contract to provide coverage is placed in *no better* and in no worse position than if it had assumed coverage when considering whether it acted in good faith in refusing to settle.[41]

This is practically verbatim the *Comunale* or strict liability rule.[42] Like the strict liability standard, which expressly approves of the "equal consideration" test,[43] the concurring opinion negates the nexus between coverage denial and settlement refusal. Its instructions require the insurance company to put itself in the *hypothetical* circumstance of defending the insured on the merits. Since that hypothetical, by definition, rules out a good faith denial of coverage, the opinion forbids the insurer, in cases like *Luke* in which the insured is clearly at fault in causing the accident, to rely on the only reason it has for not settling. With its interest obliterated, the company has nothing with which to balance against the insured's undiminished interest in having the settlement offer accepted. The real effect of the holding is to slide "at least equal consideration" to "paramount consideration of the insured's interests." As noted in the discussion of "relative interests,"[44] the practical consequence of the latter standard is strict liability whenever an insured rejects a settlement within policy limits and coverage is later held to have obtained. Thus, acceptance of a reasonable offer is mandated.

Luke is a particularly valuable study in the movable link between denial of coverage and the refusal to settle since all three positions regarding the nexus issue were applied at some point in the case. The

40. *Id.*
41. 476 F.2d at 1023.
42. 50 Cal. 2d at 660, 328 P.2d at 202; *see* note 4 *supra.*
43. 50 Cal. 2d at 659, 328 P.2d at 201.
44. *See* text accompanying notes 28-32 *supra.*

district court used the "insulation" rule, the dissent on rehearing en banc used the "middle" or "evidentiary" view, and the concurring opinion used the "strict liability" standard. Not a single judge embraced anything other than the "good faith-equal consideration" test, yet three different conclusions resulted. In fairness to judges and litigants alike, each jurisdiction should identify its position on the relationship between coverage denial and settlement refusal and make that position explicit as a third dimension of the "good faith-equal consideration" standard. Unless a clear declaration is made, the nexus issue can continue to be an escalator taking courts from "insulation" to "strict liability" under the banner of "good faith-equal consideration."

Knowing how a court reaches a decision has merit, but perhaps a more pertinent inquiry for insurers is what they can do to protect themselves in a situation like *Luke*. The concurring opinion implies a solution in the first reason[45] it gives for finding bad faith as a matter of law: "[t]he record shows that once the insurer refused coverage it failed to investigate further . . . ."[46] The material facts, however, were undisputed. The only unresolved issue was how the court would interpret the coverage exclusion defense; consequently, the only further investigation the company could have done was in court by way of declaratory judgment. By implication, the lesson the concurring judges seem to be impressing upon insurers is to be absolutely certain before abandoning the insured and only through an adjudication of rights can that certainty be achieved. Perhaps the concurring opinion had in mind a rule like the one posed by *Country Mutual Insurance Co. v. Murray*:

> if the carrier refuses to provide its insured an unrestricted defense, yet desires to ultimately urge exclusionary coverage defenses, it must;
>
> (1) *Secure* a declaratory judgment of its rights and obligations, while defending its potential insured on a reservation of rights, or

45. The second reason—not considering the excess damages its insured might suffer—begs the question whether the tortfeasor was in fact the company's insured for the purposes of the litigation instituted by the injured party and raises the issue whether the insured has suffered any damages until he actually expends his own resources to discharge the adverse judgment. For a discussion of recovery by semi-solvent insureds when there has been a bad faith refusal to settle within policy limits, *see* Comment, *Bad Faith Failure to Settle Within Policy Limits: Recovery by Semi-Solvent Insureds*, 61 GEO. L.J. 1525 (1973); Recent Decision, *Insurance—Insurer's Liability for an Excess Judgement Following a Wrongful Refusal to Settle Within Policy Limits*, 22 J. PUB. L. 271 (1973).

46. 476 F.2d at 1023.

(2) Defend its potential insured on a reservation of rights and adjudicate its coverage in a supplemental suit.[47]

In either instance the insurer can eventually argue its policy defense without risking excess liability and without abandoning the insured. Although the declaratory judgment alternative presents difficulties,[48] its possibilities appear brightest in cases like *Luke*, in which the adjudication of the insurer's rights has no bearing whatever on the insured's tortious liability.

If the concurring judges wanted to adopt the procedure outlined by *Murray*, they should have done more than merely hint at their desire. Maybe the judges were simply advocating the strict liability rule, but to avoid *Erie* problems,[49] they reached the same result obliquely. The debate over the economic consequences of strict liability still rages,[50] and the expansion of the limited-risk concept of liability insurance in connection with "no fault" has commanded national attention. Accordingly, one would hope that any attempt to hold insurance carriers to greater liability than appears in the contract of insurance would be done openly rather than through deceptive terminology.[51]

Whatever their intent, the concurring judges have helped to expose how the relationship between good faith coverage denial and the duty to settle can be manipulated to protect insurers or to impose strict liability on them. Surely this movable link should be riveted into place so that consistent results may be achieved from application of the "good faith-equal consideration" standard.

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47. 97 Ill. App. 2d 61, 73, 239 N.E.2d 498, 505 (1968).

48. *See, e.g.*, Western Cas. & Sur. Co. v. Herman, 405 F.2d 121 (8th Cir. 1968). *See generally* Blakslee, *Conflict of Interests: Insurance Cases*, 55 A.B.A.J. 262 (1969); Note, *Use of the Declaratory Judgment to Determine a Liability Insurer's Duty to Defend—Conflict of Interests*, 41 IND. L.J. 87 (1965).

49. Erie R.R. v. Tompkins, 304 U.S. 64 (1938). Adoption of the *Comunale* rule clearly would conflict with standards set forth by the South Dakota Supreme Court in *Kunkel*. Despite the concurring judges' rejection of *Comunale*, they repudiated the "evidentiary relationship" between coverage denial and settlement refusal espoused by *Kunkel*. Thus, Judge Bright concluded that "the majority has ignored the local law in this diversity case contrary to the mandate of [*Erie*]." 476 F.2d at 1026.

50. *Compare* Note, *Insurance—Liability of an Insurer Beyond Policy Limits—The Danger of Strict Liability*, 47 N.C.L. REV. 453 (1969), *with* Comment, *Insurance—Excess Recovery—Liability Insurer Who Refused Settlement Within the Policy Limits Held Liable for Excess Recovery and Mental Damages*, 43 N.Y.U.L. REV. 199 (1968), *and* Comment, *An Insurance Company's Duty to Settle: Qualified or Absolute?*, 41 S. CAL. L. REV. 120 (1968).

51. For example, because *Comunale* expressly adopted the implied contract concept to require insurers to accept reasonable offers, it has furnished valuable input in the discussion of the future of liability insurance. *See* notes 2-4 *supra*.