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Recent Developments in North Carolina Case Law (December 1973 to February 1975)

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Administrative Law—Proceedings Under the North Carolina Occupational Safety and Health Act

Growing out of increased congressional concern over job injuries and the economic disincentives to improve working conditions offered by the worker's compensation programs, the Williams-Steiger Occupational Safety and Health Act of 1970 was enacted by Congress.[1] Already in the brief three-year existence of the program, the federal OSHA has generated a vast amount of legal commentary over its legitimacy.[2] The Act was designed to unify all existing federal safety programs and to promulgate standards for working safety to meet the hazards of the future. To achieve these goals, federal OSHA directs the United States Secretary of Labor, with the advice of the National Institute for Occupational Safety and Health (NIOSH) and the National Advisory Council on Occupational Safety and Health (NACOSH), to adopt minimum safety standards for various industrial classifications.[3] In addition, the United States Department of Labor is responsible for enforcing these standards.[4] This enforcement is accomplished by safety compliance officers operating out of regional offices.[5]

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1. 29 U.S.C. §§ 651-76 (1970).

2. *See, e.g.*, Brady, *The New Occupational Safety and Health Act—Its Impact on Contractors and Sureties*, 8 FORUM (A.B.A.) 114 (1972); Cohen, *The Occupational Safety and Health Act: A Labor Lawyer's Overview*, 33 OHIO ST. L.J. 788 (1972); Greenberg, *OSHA: More Headaches for the Building Industry*, 7 PUB. CONTRACT L.J. 106 (1974); Heath, *Implementation and Philosophy of the Williams-Steiger Occupational Safety and Health Act of 1970*, 25 U. FLA. L. REV. 249 (1973); Hornberger, *Occupational Safety and Health Act of 1970*, 21 CLEV. ST. L. REV. 1 (1972); Moran, *A Critique of the Occupational Safety and Health Act of 1970*, 67 NW. U.L. REV. 249 (1973); Moran, *The General Duty Clause of the Occupational Safety and Health Act of 1970*, 86 HARV. L. REV. 988 (1973); Moran, *How to Obtain Job Safety Justice*, 24 LAB. L.J. 387 (1973); Moran, *Parties to Proceedings in the Court of Appeals Under the Occupational Safety and Health Act of 1970*, 15 B.C. IND. & COM. L. REV. 1089 (1974); Mullins, *OSHA—The Federal Government and Job Safety*, 19 ROCKY MT. MINERAL L. INST. 155 (1974); Satter, *Shedding Some Light on the Burden of Proof in Demonstrating a Violation of the General Duty Clause of OSHA: National Realty*, 15 B.C. IND. & COM. L. REV. 1075 (1974); Spann, *The New Occupational Safety and Health Act*, 58 A.B.A.J. 225 (1972); White, *Occupational Safety and Health—A New Area of the Law for the Legal Practitioner*, 61 ILL. B.J. 522 (1973); Special Section, *The Occupational Safety and Health Act of 1970*, 20 WAYNE L. REV. 987 (1974); Symposium, 9 GONZAGA L. REV. 317 (1974); Symposium: *Occupational Safety and Health*, 9 TRIAL, July-Aug. 1973, at 12.

3. 29 U.S.C. §§ 655-56 (1970).

4. *Id.* §§ 655-58.

5. *See The President's Report on Occupational Safety and Health for 1972*, CCH

The federal OSHA, however, provides for the development of state plans, under Department of Labor supervision, to allow local enforcement of health and safety standards.[6] During the developmental phase of these state programs, the United States Department of Labor and the corresponding state enforcement agencies share concurrent jurisdiction. However, when fully operational, the state agency takes over all responsibility for enforcement, at least for those standards the state has chosen to adopt. North Carolina has promulgated a state OSHA program that is patterned on the federal Act with a few deviations.[7] This program is now in full operation and is functioning under a probationary status until full approval is granted, a step expected within the next year. The purpose of the State Act is "to assure so far as possible, every working man and woman in the State of North Carolina safe and healthful working conditions and to preserve our human resources."[8]

North Carolina has chosen to assume enforcement of all of the federal safety standards except those dealing with maritime or longshoreman operations.[9] The major areas of regulation are general industry and construction safety and exposure to toxic substances.[10] Topics dealt with in these regulations include, among other items, the shoring of excavations, personal protective equipment in dangerous areas such as steel-toe shoes and hard-hats, guards for exposed operating equipment, and the amount of toxic chemicals allowed in the air of manufacturing plants.[11] Every employer in the State must comply with these standards and keep extensive records on all occupational injuries and diseases.[12]

EMP. SAFETY & HEALTH GUIDE—SPECIAL REPORT, February 24, 1974, at 59-60. Eleven regional offices have been set up in Boston, New York, Philadelphia, Atlanta, Chicago, Dallas, Kansas City, Denver, San Francisco, and Seattle. *See also* 29 U.S.C. § 657 (1970).

6. *Id.* §§ 667, 672(f)-(g), 673(c). Thirty-six states are presently developing enforcement plans, Nineteen states, including North Carolina, have plans in operation on a probationary basis. Three states have fully operational plans completely run by the state.

7. N.C. GEN. STAT. §§ 95-126 to -155 (Supp. 1974).

8. *Id.* § 95-126(b)(2).

9. *Id.* § 95-131. The Commissioner has adopted the General Industry Standards and the Construction Standards as a first step in the North Carolina standard program.

10. The North Carolina Department of Labor will automatically adopt all new federal consensus standards as they are promulgated. In addition, special standards may be adopted by the North Carolina Commissioner of Labor with the advice of the North Carolina Advisory Council and the approval of the federal area directors. N.C. GEN. STAT. § 95-131 (Supp. 1974).

11. The federal standards are contained in 29 C.F.R. § 1910 (1973).

12. Employers with less than 8 employees have recently been exempted from the record-keeping requirements.

ENFORCEMENT PROCEEDINGS

Under the North Carolina Act, the State Department of Labor has the responsibility for enforcing the safety standards in the State.[13] A team of safety compliance officers conducts inspections of premises looking for violations.[14] These officers are given full administrative search authority by N.C. OSHA, a right that has been constitutionally upheld at the federal level.[15] If a violation is found, the inspector points it out to the employer and notes it in his inspection report. If the condition is considered to present an imminent danger to the safety of employees, the State Department of Labor can take immediate steps to halt operations by applying directly to the judiciary for an injunction.[16]

In ordinary situations, the safety officer reports any alleged violations to the Director of the Office of Occupational Safety and Health, who within several days, will issue a formal citation that carries an abatement date and may carry a proposed penalty.[17] If the employer does not contest the citation, abatement date, or penalty, they become final orders of the Review Board after fifteen working days.[18] After the employer has had time to correct the unsafe conditions, a follow-up inspection is conducted to insure that action has been taken.

The Act provides, however, that a citation may be challenged in an administrative hearing in three ways. First, the employer may contest the citation, abatement date, or proposed penalty by a simple letter notice of contest addressed to the Director of OSHA.[19] The employer may also initiate a hearing by requesting a modification of abatement date after the citation has become final.[20] Usually such a request must be approved by the Director of OSHA; however, if he denies the request, the employer may appeal administratively.[21]

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13. N.C. GEN. STAT. §§ 95-126(b)(2)(c), (m), -133 (Supp. 1974).

14. *Id.* § 95-136. The detailed procedures for inspections are contained in OCCUPATIONAL SAFETY AND HEALTH DIVISION, NORTH CAROLINA DEPARTMENT OF LABOR, OSHA FIELD OPERATIONS MANUAL (1974) [hereinafter cited as OPERATIONS MANUAL].

15. 29 U.S.C. § 657 (1970). *See* Brennan v. Buckeye Indus., Inc., 374 F. Supp. 1350 (S.D. Ga. 1974).

16. N.C. GEN. STAT. § 95-140 (Supp. 1974).

17. *Id.* § 95-137. *See* OPERATIONS MANUAL, *supra* note 14, ch. IX, at 1-18.

18. N.C. GEN. STAT. § 95-137(b)(1) (Supp. 1974).

19. *Id.* § 95-137(b)(4). *See* NORTH CAROLINA OCCUPATIONAL SAFETY AND HEALTH REVIEW BOARD RULES OF PROCEDURE, rule 32 (1975) [hereinafter cited as REVIEW BD. R. —].

20. REVIEW BD. R. 34.

21. *Id.*

Thirdly, the employees affected by unsafe conditions may initiate a hearing on the appropriateness of the abatement period given their employer by a letter of contest when they feel their safety is threatened by an exceedingly long abatement-correction time.[22]

These administrative hearings are determined before an independent body, the North Carolina Occupational Safety and Health Review Board.[23] This agency is charged only with the resolution of disputes that might arise under N.C. OSHA and has no enforcement authority.[24] Within the Review Board, there are two levels of adjudication.[25] First, the fact-finding hearing is conducted by a hearing examiner who is empowered to take evidence, rule on motions, and issue final orders of decision.[26] Three hearing examiners are located in different regions of the State.[27] Their decisions become final orders of the Review Board unless the Board, within thirty days, directs that the case be brought before it for review.[28] This may be accomplished by motion of any one of the three Review Board members upon petition of any party.[29] Secondly, the Review Board hearing is generally based on the hearing examiner's findings of fact and additional evidence can be introduced only pursuant to a special motion of the Board.[30] The standard of review has not been definitively defined. Apparently, the findings of the hearing examiner will be sustained if supported by the weight of the evidence. The legal ruling, however, is open to modification if the Review Board decides that it is in error.[31] A more substantial standard is needed if the review is not to be completely arbitrary. Trial decisions are entitled to some validity or they should not

22. N.C. GEN. STAT. § 95-130(11) (Supp. 1974).

23. *Compare id.* § 93-135 *with* 29 U.S.C. § 661 (1970).

24. N.C. GEN. STAT. § 95-135 (Supp. 1974). *See* Cleary, *Pleading and Practice Before the Occupational Safety and Health Review Commission*, 24 LAB. L.J. 779 (1973); *cf.* Moran, *A Court in the Executive Branch of Government: The Strange Case of the Occupational Safety and Health Review Commission*, 20 WAYNE L. REV. 999, 1008-13 (1974) and cases cited therein.

25. *See* N.C. GEN. STAT. § 95-131(i) (Supp. 1974).

26. *See id.*

27. They are Hugh M. Wilson (Lenoir, N.C.), Fred Hutchins, Jr. (Winston-Salem, N.C.), and George Rountree, III (Wilmington, N.C.).

28. N.C. GEN. STAT. § 95-135(i) (Supp. 1974).

29. *Id. See also* REVIEW BD. R. 91. Theoretically, the Review Board could direct a case for review even if no party requested such, and the federal Review Commission has done so. *E.g.*, Brennan v. Occupational Safety & Health Review Comm'n, 505 F.2d 869 (10th Cir. 1974). However, the appeal does not seem very worthwhile as all real parties in interest no longer have any stake in the case. *But see id.* at 871.

30. REVIEW BD. R. 91(d).

31. *See* Carolina Welds Plant, Docket No. 1 (OSHANC Review Bd., Jan. 17, 1974) (dissenting opinion).

be conducted. Based on federal experience, a rule of upholding the hearing examiner's conclusions of law except where clearly erroneous would seem to be workable.

A party aggrieved by a ruling of the Review Board then has recourse to the State court system under the provisions of the North Carolina Administrative Procedure Act.[32] If federal precedents are followed, the aggrieved party will be required to exhaust his administrative remedies by petitioning the Review Board for review before he may seek judicial relief.[33] If a party fails to appeal to the Board within the thirty-day appeal period, further proceedings would seem to be precluded.[34] Because the Review Board presumptively has expertise in safety and engineering, their decisions are presumed valid. Thus the courts, in exercising judicial review in OSHA matters, can set aside Review Board decisions only if they are found arbitrary and capricious, unconstitutional, or wholly unsupported by the evidence.[35]

PLEADING AND PRACTICE

Pleading and practice before the adjudicatory levels of the Review Board are governed by internally created Review Board Rules of Procedure.[36] The OSHA Review Board is specifically excluded from the coverage of the Administrative Procedure Act;[37] however, the Board's statutorily authorized rules must conform to the North Carolina Rules of Civil Procedure as closely as possible.[38] The Rules of Civil Procedure are directly applicable whenever the Review Board has not authorized a different rule.[39] Under the Board rules, a complex pleading system has developed which effectively requires more specificity than the Rules of Civil Procedure.

In practice, after a case is originated by a notice of contest (either from the employer or the employee), the Department of Labor must

32. N.C. GEN. STAT. § 150A-1 to -52 (Supp. 1974). *See generally* Daye, *North Carolina's New Administrative Procedure Act: An Interpretive Analysis*, 53 N.C.L. REV. 833 (1975).

33. *See* Frank Irey, Jr., Inc. v. Hodgson, 354 F. Supp. 20, 21 (N.D.W. Va. 1972), *aff'd mem.*, 409 U.S. 1070 (1972).

34. *See id.*

35. See, *e.g.*, Brennan v. Occupational Safety & Health Review Comm'n, 501 F.2d 1196, 1198-99 (7th Cir. 1974); Brennan v. Occupational Safety & Health Review Comm'n, 491 F.2d 1340, 1344 (2d Cir. 1974); Brennan v. Occupational Safety & Health Review Comm'n, 487 F.2d 438, 442 (8th Cir. 1973).

36. N.C. GEN. STAT. § 95-135(d), (e) (Supp. 1974).

37. *Id.* § 150A-1(a).

38. *Id.* § 95-135(d).

39. *Id.*; REVIEW BD. R. 2.

respond with a detailed complaint within twenty days.[40] The respondent then has fifteen days to answer with specific objections and defenses.[41] Such a system, while requiring considerable effort, does limit the scope of the administrative hearing. Since factual issues are rarely in dispute, a more limited trial saves time and money. Leave to amend pleadings to conform to the evidence has not been readily granted to either party at the federal level and the North Carolina Review Board appears to be following the practice.[42]

The Review Board Rules of Procedure make far less use of party-initiated pretrial procedures than do the Rules of Civil Procedure.[43] Pretrial discovery is discouraged and, in fact, practically eliminated;[44] however, depositions, subpoenas, and interloctuory orders can be issued by the hearing examiners or any Board member.[45] They can then be enforced in the courts upon petition of any party, much like Industrial Commission or other administrative orders.[46] The Review Board has not liberally granted such requests.[47] The Board's position is that all fact-finding should occur at the hearing and not independently. While this position results in voluminous hearings, it does insure that there will not be a long delay for discovery before the hearing is held. The Review Board has a vested interest in seeing that no employee is exposed to an unabated hazard any longer than the minimum time necessary to resolve all issues. The employer's notice of contest sus-

40. REVIEW BD. R. 33, 35.

41. *Id.* 33(b).

42. *See* Ames Associates, Inc., Docket No. 10 (OSHANC Review Bd., Aug. 28, 1974) (A construction company was cited for failure to require its employees to wear life-lines and safety belts while working on an open roof fifty feet in the air. The complainant tried to amend its charge to allege failure to provide construction guardrails and a repeated violation but after consultation this was refused). *See also* Gastonia Sheet Metal, Inc., Docket No. 16 (OSHANC Review Bd., Jan. 7, 1975).

43. *See, e.g.*, REVIEW BD. R. 33, 34, 35, and 53. Two cases have had citations overturned for failure to comply with the Rules of the Review Board. Gastonia Sheet Metal Works, Inc., Docket No. 16 (OSHANC Review Bd., Jan. 14, 1975); Herman Erection Co., Docket No. 13 (OSHANC Review Bd., Dec. 30, 1974). The original January 1974 draft of the rules was considered to be simple guidelines and supplementary to the Rules of Civil Procedure. However, federal objections to the lack of specificity and the need for more formalized proceedings led to a comprehensive procedural system unique to the Review Board. These new rules then went through several subsequent drafts before the January 1975 version was finalized.

44. REVIEW BD. R. 53. Discovery has been allowed in only one case—Dan River, Inc., Webco Knit Div., Docket No. 18 (OSHANC Review Bd., contest received Dec. 20, 1974, pending).

45. N.C. GEN. STAT. § 95-135(d) (Supp. 1974); REVIEW BD. R. 53.

46. REVIEW BD. R. 54, 55(d).

47. *See* International Chem. Workers Union, Docket No. 11 (OSHANC Review Bd., Nov. 27, 1974).

pends the running of any abatement period while it is being determined; therefore, the hearing must be held as soon as possible to insure that a dangerous condition is eliminated in minimum time.[48]

SETTLEMENT

In keeping with the directive of the federal OSHA director that abatement and voluntary compliance are the chief goals of all developmental operations,[49] settlement of penalties has been very common.[50] The decision to carry a citation to a full hearing must be very carefully weighed by the corporate attorney contemplating contest.[51] The cost of conducting a hearing and obtaining expert and common testimony must be compared to the possible benefit to be gained from administrative adjudication. The usual result is only a small reduction in penalties—an outcome more easily obtained through the settlement apparatus.[52] The Department of Labor will generally reduce a penalty to a nominal amount when future compliance is assured and abatement dates are affirmed.[53]

The Review Board, unlike the Labor Department, has been reluctant to allow contested cases to be settled.[54] They contend that this practice circumvents the Review Board's powers of supervision. To retain some control, the Review Board Rules of Procedure divide settlements into two classes. A rule 50 withdrawal of contest is appropriate when the respondent declines to carry forward his contest.[55] The Review Board does not enter the adjudicatory process because the penalty, citation, and abatement date must be fully complied with. If any of these factors are modified or negotiated in any way, a second form of approval by the Review Board is required by rule 100.[56] This ar-

48. N.C. GEN. STAT. 138(a) (Supp. 1974).

49. Address by Mr. William Stender, Second Annual Conference on Occupational Safety and Health, Aug. 14, 1974.

50. *See* Memorandum from Ray Boylston, Director-OSHANC, to W.C. Creel, N.C. Commissioner of Labor, Jan. 22, 1975, on file in the Review Board office. About sixty percent of contested cases end in settlement. *Id.*

51. Other factors to consider are the average time for adjudication (currently about six weeks) and the damage to the public image of a firm.

52. Settlement commonly reduces a serious violation to a non-serious violation as long as guilt is acknowledged for an assurance of future compliance.

53. *See* OPERATIONS MANUAL, *supra* note 14, for general directives on future compliance efforts (principally ch. III). *See also* Peden Steel Co., Docket No. 14 (OSHANC Review Bd., Jan. 15, 1975).

54. *See* note 60 *infra.*

55. REVIEW BD. R. 50.

56. *Id.* 100.

rangement is classified as a settlement and is subject to the simple approval of the Board.

This power of approving settlements appears to be mainly illusory, however. If the Review Board directs a settlement for review, there would be no remaining dispute between the parties and the Review Board would have to take a non-judicial stance. When the federal Review Commission has taken such action and the decision brought before the United States court of appeals, the court has been generally disapproving.[57] *Dale M. Madden Construction, Inc. v. Hodgson*[58] held that enforcement is the primary responsibility of the United States Department of Labor. Penalty settlement, even after the Review Commission has made another determination, is permissible and cannot be challenged by the Review Board.[59] No situation has yet arisen in North Carolina in which the North Carolina Review Board has refused to approve a settlement. If the Labor Department should refuse to submit its settlement for review, the Review Board would be left with the task of adjudicating a non-existent controversy.[60] In practicality, the Director of North Carolina OSHA will be given a free hand in settling penalties and the Review Board will be unable to exercise any supervisory power.[61]

EMPLOYEE RIGHTS

Employees under North Carolina OSHA must comply with all standards. Apparently, failure to do so could be cause for dismissal of an employee when the employer is cited for a violation. However,

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57. *See, e.g.*, Brennan v. Occupational Safety & Health Review Comm'n, 502 F.2d 946 (3rd Cir. 1974); Dale M. Madded Constr., Inc. v. Hodgson, 502 F.2d 278 (9th Cir. 1974); Brennan v. Southern Contractors Serv., 492 F.2d 498 (5th Cir. 1974); Brennan v. Occupational Safety and Health Review Comm'n, 487 F.2d 230 (5th Cir. 1973).

58. 502 F.2d 278, 280 (9th Cir. 1974).

59. *Id.*

60. Such was the case with W.E. Dansey Co., Docket No. 8 (OSHANC Review Bd., Aug. 28, 1974), decided before the Rules of Procedure were modified. The administrative law judge refused to dismiss the case even though the respondent failed to appear and had communicated a desire to withdraw. The representative of the Labor Department was required to present evidence to justify the citation issued. What would have occurred if the Director had refused to proceed is uncertain. *See also* Suburban Elec. Serv., Docket No. 9 (OSHANC Review Bd., Aug. 28, 1974).

61. The four settlements or withdrawals processed by the Review Board after the rules were changed have been approved without comment. *See* Joseph P. Schlitz Brewing Co., Docket No. 23 (OSHANC Review Bd., Jan. 15, 1975); Southworth Constr. Co., Docket No. 15 (OSHANC Review Bd., Jan. 8, 1975); Peden Steel Co., Docket No. 14 (OSHANC Review Bd., Dec. 6, 1974); Pargo, Inc., Docket No. 12 (OSHANC Review Bd., Nov. 1, 1974).

employees cannot be directly penalized under the Act.[62] The justification for this non-liability of the employee has been stated to be either that he does not have control over working conditions or that since the Act is designed to protect the employee, he should not suffer its penalties. Nevertheless, the actual reason for this policy decision is the impossibility of enforcement and the possibility of unconstitutionality. The employer is in the financial position to purchase safety equipment, not the employee. Also the direct levy of a fine on a person rather than a business resembles criminal proceedings requiring procedural protections. Thus, the best decision is to leave supervision of the employees to the employer and focus the sanctions of the Act on the employer in charge.

In return for this elusive duty to comply with OSHA, employees are given several rights to proceed under the Act to protect their safety. Employees can effectively insure that their employer takes action to bring his plant into compliance with OSHA. They can report any condition that they feel is unsafe directly to the Department of Labor.[63] The Director is then statutorily obligated to investigate and make a full report on these complaints.[64] Such employee complaints have generated most of the inspections made in North Carolina—union representatives often acting as watchdogs of the employer by issuing direct periodic reports.[65]

Additionally, the Review Board is commanded by the Act to give employees or their representatives an opportunity to participate directly in all proceedings that directly affect their welfare.[66] In contrast to the federal practice of allowing employees to participate freely in all proceedings initiated by the employer, the State Review Board Rules of Procedure require employees to go through formal intervention proceedings under rule 21.[67] In essence, this procedure consists of a petition for leave to intervene that places the burden of proof on the petitioner to demonstrate how his participation will assist in determination of the issues in dispute. Only one union has tried to utilize this procedure, a fact which places some emphasis on the difficulty an em-

62. N.C. GEN. STAT. § 95-130 (Supp. 1974).
63. *Id.* §§ 95-130(6), (7).
64. *Id.* §§ 95-136(d)(1), (2).
65. *See* Babcock & Wilcox, Inc., Docket No. 22 (OSHANC Review Bd., contest received Jan. 19, 1975, pending); International Chem. Workers Union, Docket No. 11 (OSHANC Review Bd., Nov. 27, 1974).
66. N.C. GEN. STAT. § 95-135(e) (Supp. 1974).
67. REVIEW BD. R. 21.

ployee faces in marshalling evidence to substantiate his intervention.[68] Another reason for the lack of union use of the procedure is that the North Carolina provisions do not provide union representatives with direct notification of OSHA activity by the employer.[69]

There are two policies supporting this reluctance to give employees free access to employer proceedings. First, employees would probably have little to add to the evidence that would be competent in prosecuting the employer. In fact, an employer might coerce his employees to appear at a hearing with glowing reports of a safety program in the company that did not exist. Secondly, a three party proceeding does not seem logically to conform to a criminal-style trial with accused and accusor. The State OSHA plans were not set up to give employees a chance to sue their employers or air in-company grievances. Giving employees an opportunity to accuse their employer in an administrative hearing seems to leave the issue of industrial safety far behind.

A final right given the employee is that of challenging an abatement date.[70] An employee has twenty days after the posting of the citation or any subsequent amendments to send a notice of contest to the Department of Labor.[71] The Department of Labor must then within fifteen days plead a justification of the abatement granted and the employee has ten days to respond with specific objections.[72] Thus the burden of pleading and going forward is placed on the Department of Labor, and the employee can force detailed explanations of the Department's actions by a simple challenge. While this procedure may be burdensome on the Department, the right was granted to give the employee the same power that the employer has in challenging a citation.[73] The situation is not exactly the same, however, because while the employee is not subject to any penalties for failure to abate, the employer is. A better solution—the one originally imposed by the Review

68. *See* Babcock & Wilcox, Inc., Docket No. 22 (OSHANC Review Bd., contest received Jan. 19, 1975, pending).

69. *See* REVIEW BD. R. 7(e). The federal practice is to require an employer to serve notice of all OSHA activity on the employee collective bargaining agent.

70. N.C. GEN. STAT. § 95-130(11) (Supp. 1974).

71. *Id. See also* REVIEW BD. R. 35.

72. REVIEW BD. R. 35.

73. In the earlier drafts of the Review Board Rules of Procedure, the employee had the burden of pleading facts tending to show that the original abatement date was unreasonable. In the January 1975 draft of the Rules, however, that requirement was changed to place the burden of pleading on the Labor Department to show why its abatement date is reasonable. This change again came about because of federal pressure to bring the state plans into conformity with the federal practice.

Board rules—would be to require the employee to plead evidence sufficient to suggest that the abatement date granted was arbitrary or capricious. The expertise for deciding an appropriate abatement date lies with the Director not the Review Board. The Review Board should logically be able only to approve or disapprove an abatement suggested by the Director. Nevertheless, the job of evaluating all factors that go into specifying abatement has been given to the Review Board. In the absence of a standard of review, the evidence of the employee is entitled to equal weight with that of the Director and the abatement date must be determined *de novo*.

MODIFICATION OF ABATEMENT

Analogous to the employee challenge to abatement, the employer, after his fifteen day original contest period has expired, may petition the Director for a modification of the date or a suspension of the period altogether when he shows that he will not be able to comply with the original date for reasons beyond his control.[74] From a denial of this request, the employer may appeal to the Review Board. Clearly, the employer has the burden of proof under this proceeding to show that the action taken was arbitrary and capricious.[75] He then must show why his extension is justified. Again, the Review Board has the responsibility of determining an abatement date—a function the Board is not qualified to perform as they have no access to technical experts. A better procedure would require the Review Board only to approve or disapprove the abatement date with the burden of proving that the action was "unreasonable" on the employer.

PENALTIES

North Carolina OSHA provides for both civil and criminal penalties,[76] but the Review Board has jurisdiction only over civil penalties. Criminal penalties, which are appropriate only when unsafe conditions have resulted in a fatality, are imposed by the State superior court upon petition of the Labor Department.[77] The civil penalties meted out by

74. REVIEW BD. R. 34.

75. *Id.* 73. This raises the question of whether a procedural rule can shift the burden of proof without a judicial determination.

76. N.C. GEN. STAT. §§ 95-138, -139 (Supp. 1974).

77. *Id.* § 95-139. *See* NORTH CAROLINA OCCUPATIONAL SAFETY AND HEALTH REVIEW BOARD, A GUIDE TO APPEAL PROCEEDINGS UNDER THE OCCUPATIONAL SAFETY AND HEALTH ACT OF NORTH CAROLINA 5 (1975).

the Review Board range from 10,000 dollars for a willful violation to less than 100 dollars for a non-serious violation.[78] Violations are classified as willful or repeated when the same violation was cited previously.[79] Serious violations that carry an unadjusted penalty of 1000 dollars require the probability of "serious injury"[80] and actual or constructive knowledge of the hazardous condition by the supervisor of the job site. Non-serious violations are all other conditions that carry a probability of harm but do not present an immediate serious hazard.[81] They require no knowledge on the part of the company and are thus simple statutory violations.

The amount of the penalty to be assessed, once a contest reaches the hearing stage, lies in the sole province of the hearing examiner or Review Board. The Director decides only "proposed penalties."[82] This recommendation is not to be given controlling weight at least in theory. In practice, the administrative judge, in fixing penalties, relies heavily on the Director's determination of penalty based on the size of the cited business, the seriousness of the violation, past safety history, and the showing of good faith in abatement.[83] In most cases, the penalty is either affirmed as originally decided or reduced to a nominal amount.[84] This approach appears to be the only practical solution because the Review Board does not have the information to decide differently unless a plea is made by the employer professing economic destruction.[85]

Some question has arisen about the Review Board's power to increase a proposed penalty when contested. The federal Review Commission has approved several such increases; nonetheless, due process would appear to preclude an increase because an employer would be effectively penalized for exercising his right of appeal.[86] On the other

78. N.C. GEN. STAT. § 95-138 (Supp. 1974).

79. *See* OPERATIONS MANUAL, *supra* note 14, ch. X, at 1-4, 7, 16-17.

80. *Id. See also id.*, ch. VII, at 6-9.

81. *Id.*

82. *See id.*, ch. IX, at 1-17; *cf.* Brennan v. Occupational Safety & Health Review Comm'n, 487 F.2d 438 (8th Cir. 1973).

83. OPERATIONS MANUAL, *supra* note 14, ch. X, at 2-7.

84. *See* Carolina Welds Plant, Inc., Docket No. 1 (OSHANC Review Bd., order of hearing examiner, June 17, 1974).

85. The technical specialists are employed by the Labor Department and not the Review Board. Economic feasibility is also best left to the Labor Department since the Review Board can only obtain a vague picture of economic conditions from evidence presented.

86. *See, e.g.*, Allied Structural Steel Co., CCH 1974-75 OCCUP. SAFETY & HEALTH DEC. ¶ 19,184 (Jan. 7, 1975).

hand, the penalty-setting process is accomplished *de novo* by the administrative judge. In the same manner that a criminal conviction in North Carolina appealed from district to superior court is tried *de novo* with the possibility that additional penalties may be levied, there is some support for the position that the entire amount of the penalty is challenged by a contest and may thus be increased.[87] A final resolution of this question awaits judicial determination.

DEFENSES TO CITATIONS

While still in the beginning stages, several common defenses have appeared that eliminate the liability of the employer. The federal Act and the administrative search provisions have withstood several tests of constitutionality at the federal appellate level.[88] Nevertheless, another challenge is presently awaiting rehearing *en banc* before the Third Circuit Court of Appeals.[89] The United States Supreme Court has not spoken on the issue and no such challenge has yet been made in North Carolina. Generally, such a blanket challenge to constitutionality should not be ruled upon by the administrative court because it would be deciding its own existence; however, such an issue should be raised at the administrative level to properly put it in issue before a court of review.[90]

Additionally, some of the civil penalties may be attacked as being in fact criminal sanctions and thus invalid because due process procedures such as jury trial or arraignment are not provided. Individual standards are also open to challenge for being unconstitutionally vague.[91] Several such challenges have been sustained at the federal level. Again the argument must be made at the administrative level to raise it properly on appeal. Here the administrative judge would seem to have the power to rule on such a defense at the trial.

A second category of defenses stems from the intricate procedural requirements of the Act and the Rules of Procedure. Very detailed

87. N.C. GEN. STAT. § 7A-290 (Supp. 1974).

88. *See, e.g.*, McLean Trucking Co. v. Occupational Safety & Health Comm'n, 503 F.2d 8 (4th Cir. 1974); Ryder Truck Lines, Inc. v. Brennan, 497 F.2d 230 (5th Cir. 1974); National Realty & Constr. Co. v. Occupational Safety & Health Review Comm'n, 489 F.2d 1257 (D.C. Cir. 1973).

89. *See* CCH EMP. SAFETY & HEALTH GUIDE, BULLETIN No. 192, at 1-2 (Jan. 21, 1975). The case involved is Frank Irey, Jr., Inc. v. Hodgson, 354 F. Supp. 20 (N.D.W. Va. 1972).

90. *See* cases cited note 88 *supra.*

91. *Id.*

procedures must be followed in the promulgation of a standard.[92] These procedures provide for the participation in the adoption process of the industry being regulated. If all the appropriate regulations are not followed, the standard is invalid.[93] Thus a cited employer should examine the procedural history of the standard deemed violated in planning a defense.

Additionally, service of the citation must be on an officer of the company who has the authority to correct the violation and disburse funds for payment of the penalty.[94] Thus mere service on a job foreman would probably not be sufficient. Also a very long lag between the inspection and the issuance of the citation is grounds for dismissal when some prejudice can be shown.[95] The federal issuance time suggests fifteen to twenty days as a maximum period. In industrial hygiene or toxic substances situations in which extensive laboratory analysis must be carried out before determination of compliance, this time limit is rarely observed. While perhaps not in the best interest of job safety, an improperly issued citation will provide a useful defense for the employer.

In the same manner, the procedural rules that apply to the Labor Department must be fully complied with.[96] The Rules of Procedure, which are still in the formative stages, have given rise to numerous technical dismissals of citations, generally when the Labor Department has failed to meet its deadlines for forwarding the case to the Review Board or filing a complaint.[97] This failure commonly occurs when settlement negotiations are being conducted. A respondent need only show a tenuous possibility of prejudice to avail himself of the complainant's error.[98] A more liberal interpretation of the rules is needed

92. 29 U.S.C. § 655 (1970).

93. *See, e.g.*, Synthetic Organic Chem. Mfrs. Ass'n v. Brennan, 503 F.2d 1155 (3d Cir. 1974); Brennan v. Occupational Safety & Health Review Comm'n, 502 F.2d 946 (3d Cir. 1974); Industrial Union Dep't, AFL-CIO v. Hodgson, 499 F.2d 467 (D.C. Cir. 1974).

94. *See* Buckley & Company, Inc., CCH 1973-74 Occup. Safety & Health Dec. 21, 874 (1974).

95. *See, e.g.*, Todd Shipyards Corp., 1974-75 CCH OCCUP. SAFETY & HEALTH DEC. ¶ 19,272 (Jan. 31, 1975).

96. For example, REVIEW BD. R. 32 requires the Director to transmit the original citation, abatement times, and notification of proposed penalty to the Board within seven days of receipt.

97. Gastonia Sheet Metal, Inc., Docket No. 16 (OSHANC Review Bd., March 12, 1975).

98. *Id.* The Review Board refused to uphold the argument of counsel for the Labor Department who contended that a showing of prejudice must be made before a dismissal is appropriate for failure to comply with procedures.

to stop this practice. Time extensions, which the Review Board frequently denies in keeping with its determination to bring a contested case to trial in the least possible time, should be more freely given when settlement is in process, as long as an absolute limit is placed on the negotiation.

Finally, there is currently developing a substantive defense at the federal level called the "isolated incident" doctrine.[99] This defense, which must be pleaded, seems to state that when a violation is shown to be an isolated disregard of company policy by an employee, a citation is not justified. If the employer shows that he has an active and effective OSHA safety program and that all employees have been instructed to comply with the standard allegedly violated, the citation will be dismissed as an extraordinary incident that is not the fault of the company. This defense would appear to attach some element of *mens rea* to statutes that supposedly do not require criminality for a violation. However, logically such an interpretation is often brought into purely regulatory crimes,[100] and OSHA violations may prove to be no exception. The effect is beneficial because employers now feel that they will be rewarded for compliance efforts and not just penalized for compliance failures. Good intentions, thus, can be a substantive defense.

Serious and willful violations require a higher degree of culpability than normal violations.[101] Actual knowledge or at least constructive knowledge (management *should* have known of the condition in the exercise of normal supervision) is required before these more serious penalties can be imposed.[102] At the least, the Labor Department must prove that a representative of the employer was on the job site. For instance, a team of carpenters working on a sub-contract job could not cause a citation to be drawn on their employer when he had no reason to know of the unsafe practice. Failure to prove the presence of the supervisor will result in the dismissal of the citation.

CONCLUSION

North Carolina OSHA represents a new and expanding area of ad-

99. *See* Murphy Pacific Marine Salvage Co., CCH 1974-75 OCCUP. SAFETY & HEALTH DEC. ¶ 19,025 (Nov. 14, 1974).

100. *See generally* W. LAFAVE & A. SCOTT, HANDBOOK ON CRIMINAL LAW, ch. 3 (1972); *id.* § 27, at 192-93.

101. N.C. GEN. STAT. § 95-127(18) (Supp. 1974).

102. *See, e.g.*, Colorado Fuel & Iron Steel Corp., CCH 1973-74 Occup. Safety & Health Dec. 21,410 (1973); Ira Holliday Logging Co., CCH 1971-72 Occup. Safety & Health Dec. 20,981 (1973).

ministrative law. While still in its infancy, the Act has generated a sizeable amount of litigation and legislative controversy. Though actual penalties imposed are usually quite small, costs imposed upon manufacturing companies to bring their facilities into compliance can often run into the millions of dollars. Thus a need exists for new legal expertise in this area. North Carolina practitioners need to familiarize themselves with the provisions of the Act.

While the substance of the Act appears quite solid, some legislative clarification is needed. The respective authority of the Department of Labor and the Review Board needs to be clearly delineated. The Review Board should be reconstituted to reflect its function as a purely judicial body. Authority to impose penalties should be vested entirely in the Board while supervision of abatement should be a function of the Labor Department.

GARY ROBERT CORRELL

Civil Procedure—Appeal and Error—Limiting the Effect of a Court of Appeals Interlocutory Decision on Subsequent Appeal to the Supreme Court

Prior to the addition of the court of appeals to the North Carolina appellate structure in 1965,[1] the procedural doctrine of law of the case was ostensibly followed in the State courts.[2] In *Spartan Leasing, Inc. v. Brown*[3] the North Carolina Supreme Court dealt for the first time with the law-of-the-case effect of an interlocutory decision by the court of appeals on a subsequent appeal to the highest court. The court took a distinctly modern, flexible approach to the old doctrine in finding law of the case inapplicable to supreme court review,[4] even when there had been no petition for certiorari from the interlocutory decision.[5]

Spartan Leasing, Inc., a North Carolina concern, sought damages for violations of an equipment lease. A question of personal jurisdic-

1. N.C. GEN. STAT. § 7A-16 (Cum. Supp. 1974) (originally enacted as Law of March 29, 1967, ch. 108, § 1, [1967] N.C. Sess. Laws 144).
2. Hayes v. City of Wilmington, 243 N.C. 525, 91 S.E.2d 673 (1956).
3. 285 N.C. 689, 208 S.E.2d 649 (1974).
4. *Id.* at 693, 208 S.E.2d at 652.
5. *Id.* at 699, 208 S.E.2d at 655.

tion arose, and the trial court ruled that the defendant had waived any right to object to jurisdiction by making a general appearance to request an enlargement of time. However, the court of appeals reversed and neither party petitioned for supreme court review. On remand, the trial court dismissed the action for want of sufficient in-state contact to bring North Carolina's long-arm statute into play, and the court of appeals affirmed the decision. Nevertheless, pursuant to a petition for certiorari, the supreme court reversed[6] and in so doing the court clarified two significant aspects of procedural law: (1) the status of the law of the case doctrine after the creation of the court of appeals[7] and (2) the effect of failure to seek supreme court review at the time of the interlocutory decision.[8]

The doctrine of law of the case is totally an American development in procedural law.[9] It is similar in form and rationale to the other precedential guides for courts, *stare decisis* and *res judicata.* It is a more definable standard than *stare decisis* in that no consideration of precedent is necessary; yet it is weaker than *res judicata* because it controls only the particular case in its appellate journey and has no effect on other cases involving the same issues.[10] In general, the doctrine dictates that, when a ruling of law is made by an appellate court in remanding a case for further proceedings, that ruling is binding in all subsequent stages of litigation, including a second appeal.[11] In earlier days, the doctrine was adhered to strictly,[12] but present-day application is generally more flexible with exceptions recognized in cases of "palpable error" or "manifest injustice."[13] Courts may also refuse to be bound if the ruling in question were dicta or were handed down by a divided court.[14] In addition, the doctrine generally applies only to questions that were decided, and not to those questions that could have been but were not decided.[15] The North Carolina Supreme Court itself, in approving the doctrine in 1956, ac-

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6. *Id.* at 700, 208 S.E.2d at 656.
7. *Id.* at 691-93, 208 S.E.2d at 650-52.
8. *Id.* at 694-99, 208 S.E.2d at 652-55.
9. Note, *Successive Appeals and the Law of the Case,* 62 HARV. L. REV. 286 (1948).
10. 1B J. MOORE, FEDERAL PRACTICE ¶ 0.404[1], at 403 n.12 (2d ed. 1974).
11. Note, 62 HARV. L. REV., *supra* note 9, at 286.
12. *Id.* at 287.
13. *Developments in the Law—Res Judicata,* 65 HARV. L. REV. 818, 822 (1952).
14. Note, *Law of the Case,* 5 STAN. L. REV. 751, 758 (1953).
15. 9 J. MOORE, *supra* note 10, ¶ 110.25[2], at 275. *Contra,* Note, 5 STAN. L. REV., *supra* note 14, at 758.

cepted the dicta qualification and characterized law of the case as a flexible rule of procedure.[16]

The practical reason for the existence of law of the case is to "expedit[e] final decision between the parties."[17] There are various theories justifying its application. One theory often used by courts is similar to estoppel and applies especially if the decision below were not challenged at that time or if no appeal were sought.[18] Because of the identity of parties, another rationale is associated with *res judicata* and looks to preventing harassment of one party by the repeated suits of another[19] and to the state's interest in relieving judicial burden. These policies may be fulfilled by "prohibiting matter-of-course reargument of issues already decided, preventing speculation on changes in the membership of the court, a necessary regard for the morale of the trial court which abided by the decision on the first appeal, and fairness to the parties who shaped their case on the second trial in conformity with the rulings on the first appeal."[20] No one basis applies to all situations, but they all point to one chief reason for the doctrine—"a quicker end to litigation."[21]

The rule's utility is realized best when a court is in doubt but is not convinced of its error on earlier appeal or when the rule enables a court to dispose of a question of the sufficiency of evidence.[22] It is useful in these situations primarily because it allows the court to act quickly in resolving an appeal, thus achieving the chief goal of the doctrine.[23] There are deficiencies in law of the case in such circumstances, however. To begin with, it is too indefinite to be a reliable guide for either application by courts or prediction by counsel. In fact, it cannot be applied without a reconsideration of the merits of the

16. Hayes v. City of Wilmington, 243 N.C. 525, 537, 91 S.E.2d 673, 682 (1956).

17. *Developments in the Law*, 65 HARV. L. REV., *supra* note 13, at 822.

18. This reasoning assumes that it is unfair later to complain when the other party has relied on the earlier acquiescense. *See* Note, 5 STAN. L. REV., *supra* note 14, at 756. Application of this theory could lead to a trial court binding an appellate court. *See* Hurtig v. Bjork, 258 Iowa 155, 157, 138 N.W.2d 62, 64 (1965).

19. This is not a strong rationale because the suit has not ended and is still within the control of the trial court. Note, 62 HARV. L. REV., *supra* note 9, at 289.

20. *Id.*

21. Note, 5 STAN. L. REV., *supra* note 14, at 757.

22. *E.g.*, Missouri Pac. R.R. v. Foreman, 196 Ark. 636, 119 S.W.2d 747 (1938), where the question on first appeal was whether there was sufficient evidence of liability to reach the jury. The same evidence was presented at the second trial and the Arkansas Supreme Court relied on law of the case to rule that there was no error in submitting the case to the jury at the second trial.

23. Note, 62 HARV. L. REV., *supra* note 9, at 292.

prior determination, that is, an ascertainment of whether there is manifest injustice or palpable error—time-consuming determinations that the doctrine purports to prevent.[24] Secondly, briefing and consideration of the rule often require as much time as a consideration of the merits themselves.[25]

Treatment of law of the case in various jurisdictions reflects these policies, particularly the fairness aspect. A major factor is the appealability of the interlocutory decision. State case law that rejects law of the case on supreme court review also indicates the absence of an appeal of right from the interlocutory decision.[26] Several courts characterize this factor as "flexibility."[27] While the same intermediate appellate court may be bound, the supreme court is not.[28] Still other jurisdictions refuse to apply law of the case even when there was a motion to certify that was denied.[29] Others do not appear to distinguish between review by right of appeal and by certiorari at all.[30]

Often courts refer to state procedural statutes to support their rejection of the doctrine. For example, the Michigan Supreme Court cited rules of civil procedure that authorized review of any stage of litigation as long as appeal was properly perfected.[31] The Illinois court, referring to a procedural rule authorizing immediate appeal from interlocutory orders involving injunctions and receivers, reasoned that the grant of an immediate right to appeal did not make the decision any less interlocutory. Accordingly, the court determined that the de-

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24. *Id.*

25. *Id.* at 292-93.

26. *See* City of Pueblo v. Shutt Inv. Co., 28 Colo. 524, 530, 67 P. 162, 164 (1901); Weiner v. Pictorial Paper Package Corp., 303 Mass. 123, 126-27, 20 N.E.2d 459, 460 (1939); Walker Memorial Baptist Church, Inc. v. Saunders, 285 N.Y. 462, 474, 35 N.E.2d 42, 47 (1941); Pengelly v. Thomas, 151 Ohio St. 51, 60, 84 N.E.2d 265, 269-70 (1949).

27. *See* Weiner v. Pictorial Paper Package Corp., 303 Mass. 123, 125, 20 N.E.2d 458, 460 (1939); Roach v. Los Angeles & S.L.R.R., 74 Utah 545, 572, 280 P. 1053, 1063 (1929).

28. *See* Weiner v. Pictorial Paper Package Corp., 303 Mass. 123, 127-28, 20 N.E.2d 458, 460 (1939); Grant v. Kansas City S. Ry., 190 S.W. 586, 589 (Mo. 1916); New Amsterdam Cas. Co. v. Popovich, 18 N.J. 218, 224, 113 A.2d 666, 669 (1959).

29. *See, e.g.*, Pengelly v. Thomas, 151 Ohio St. 51, 60, 84 N.E.2d 265, 269-70 (1949).

30. *See* Tomaier v. Tomaier, 23 Cal. 2d 754, 756, 146 P.2d 905, 906 (1944) (Traynor, J.); Sjostrom v. Sproule, 33 Ill. 2d 40, 41, 210 N.E.2d 209, 210 (1965) (Schaefer, J.); Grant v. Kansas City S. Ry., 190 S.W. 586, 589 (Mo. 1916).

31. Jones v. Keetch, 388 Mich. 164, 175-76, 200 N.W.2d 227, 233 (1972). The writer for the majority here is outraged at the very idea of binding the supreme court by an appeals court decision. *Id.* at 170 n.2, 200 N.W.2d at 230 n.2.

cision was not final and reviewed the entire proceeding even though earlier review was not sought.[32] More recently the Illinois court stated flatly that law of the case is "not applicable to this court in reviewing the judgment of the appellate court."[33]

The federal system has long differentiated between application of law of the case in the same appellate court and on supreme court review. Generally, a federal appellate court will not reopen its own prior decision,[34] but the rule is not "inexorable." Factors considered are justice, possibility of error, and also the possibility of United States Supreme Court review that might overturn that court's holding. Regardless of the factors considered by the court below, the Supreme Court is not bound by any lower court decision.[35] The Court articulated this concept in *United States v. United States Smelting, Refining & Mining Co.*,[36] a case in which permissible appeal was not taken from an interlocutory order. The possibility of appeal did not change the non-final character of the interlocutory decision, according to the Supreme Court, and the entire proceeding was reviewed. The Court noted that law of the case "is only a discretionary rule of practice."[37]

In *Spartan Leasing* the North Carolina Supreme Court adopted the approach of the United States Supreme Court, holding that interlocutory decisions of the court of appeals do not constitute law of the case on subsequent appeal to the supreme court.[38] After disposing of the pure law of the case issue, the court clearly indicated that the failure to petition for certiorari was the more important problem.[39] It first looked at the effect of a denial of certiorari to determine what had been foregone by the failure.[40] In the federal system, denial of certiorari has no precedential value whatsoever.[41] In *Peaseley v. Virginia Iron, Coal & Coke Co.*[42] the North Carolina court itself had held that a denial of certiorari implied no judgment on

32. Hall v. Chicago & N.W. Ry., 5 Ill. 2d 135, 147-48, 125 N.E.2d 77, 84 (1955).
33. Sjostrom v. Sproule, 33 Ill. 2d 40, 41, 210 N.E.2d 209, 210 (1965) (Schaefer, J.).
34. 9 J. MOORE, *supra* note 10, ¶ 110.25[2], at 274.
35. *Id.* at 275.
36. 339 U.S. 186 (1950).
37. *Id.* at 199.
38. 285 N.C. at 693, 208 S.E.2d at 652.
39. *Id.* at 694, 208 S.E.2d at 652.
40. *Id.* at 695-96, 208 S.E.2d at 653-54.
41. 1B J. MOORE, *supra* note 10, ¶ 0.404[5.-1], at 471. Professor Moore thinks this is wasteful judicial administration. *Id.*
42. 282 N.C. 585, 194 S.E.2d 133 (1973).

the merits and thus could not preclude later review "provided the parties have taken the *proper steps to preserve the questions for appellate review.*"[43] Arguably the emphasized language refers to all steps a party might take concerning appeal including petitioning for certiorari; however, it might also refer to the technicalities of objecting at certain stages of the trial in order to preserve the question. The latter interpretation is in accord with the North Carolina court's reference elsewhere to "proper questions on appeal" as those assigned as error and preserved by argument or citation of authorities in the brief.[44] The court has previously ruled that petitions on interlocutory decisions would be granted only when the decision affects a substantive right and would work harm to the applicant if the case proceeded to final judgment below.[45] Otherwise, the court said, a petition would be dismissed as fragmentary and premature.[46] Considering the unlikelihood of a grant of certiorari before a final resolution of the issue, one may conclude that petitioning only after resolution of all facts, as was done in *Spartan Leasing*, was in fact the "proper step" to obtain supreme court review. Indeed, the federal courts quite clearly do not penalize a party for failure to petition at the interlocutory stage,[47] and several state courts agree.[48] Referring to the policy of discouraging fragmentary appeals, the North Carolina Supreme Court accepted the federal view that a petition for certiorari is not necessary to preserve later supreme court review.[49]

Thus the court has clarified its position on law of the case without totally breaking with precedent, and in the process, has made the decision of whether to make an immediate appeal easier for lawyers. Its holding in *Spartan Leasing* is consistent with its "proper steps" language in *Peaseley*[50] and with the emphasis on law of the case as a flexible doctrine in *Hayes v. Wilmington.*[51] Moreover, the court has

43. *Id.* at 595, 194 S.E.2d at 141 (emphasis added).
44. *Id.* at 594, 194 S.E.2d at 140.
45. Steele v. Moore-Flesher Hauling Co., 260 N.C. 486, 491, 133 S.E.2d 197, 201 (1963). An obvious case of such harm would be, as Illinois recognizes, injunctions and receiverships. *See* Hall v. Chicago & N.W. Ry., 5 Ill. 2d 135, 147-48, 125 N.E.2d 77, 84 (1955).
46. Steele v. Moore-Flesher Hauling Co., 260 N.C. 486, 491, 133 S.E.2d 197, 201 (1963).
47. C. WRIGHT, HANDBOOK ON THE LAW OF FEDERAL COURTS § 106, at 477 (2d ed. 1970).
48. *See* McLaughlin v. Hahn, 333 Ill. 83, 87, 164 N.E. 148, 149 (1928); Weiner v. Pictorial Paper Package Corp., 303 Mass. 123, 127, 20 N.E.2d 458, 460 (1939).
49. 285 N.C. at 698, 208 S.E.2d at 655.
50. 282 N.C. at 595, 194 S.E.2d at 141.
51. 243 N.C. 525, 537, 91 S.E.2d 673, 682 (1956).

chosen not to penalize a party for either an inadvertent failure to petition or a wish to avoid the cost of appeal. Formerly, counsel for a potential appellant had to balance the possibility of winning on other grounds (if any) on remand in the trial court against the extra cost of an early appeal.[52] In *Spartan Leasing* the supreme court has contributed to the possibility of justice by eliminating the necessity for guessing games at the interlocutory decision level.

PHYLLIS C. JOHNSON

Civil Procedure—Resurrection of General Appearance Waiver

North Carolina's adoption of a version of the Federal Rules of Civil Procedure[1] in 1969 appeared to presage the demise of the general appearance-waiver doctrine. Nevertheless, in *Simms v. Mason's Stores, Inc.*[2] the North Carolina Supreme Court unanimously revived this doctrine that has been dormant in recent years. Although *Simms* does not firmly establish the extent of the general appearance-waiver resurrection, it does contain practical implications of importance to every North Carolina practitioner.

Simms was an action for assault initiated by a North Carolina plaintiff against a domestic corporation. After obtaining a thirty-day enlargement of time in which to answer or otherwise plead pursuant to North Carolina Rule of Civil Procedure 6(b),[3] defendant filed an answer in which he moved to dismiss.[4] Defendant's motion alleged

52. *See* Note, 5 STAN. L. REV., *supra* note 14, at 763-64.

1. N.C.R. CIV. P. 1-84.

2. 285 N.C. 145, 203 S.E.2d 769 (1974).

3. **Enlargement.**—When by these rules or by notice given thereunder or by order of the court an act is required or allowed to be done at or within a specified time, the court for cause shown may at any time in its discretion with or without motion or notice order the period enlarged if request therefor is made before the expiration of the period originally prescribed or as extended by a previous order.

N.C.R. CIV. P. 6(b). This portion of the rule is essentially identical to the FED. R. CIV. P. 6(b) counterpart.

4. The dismissal motion was pursuant to N.C.R. CIV. P. 12 that provides in pertinent part:

Defenses and objections—when and how presented—by pleading or motion—motion for judgment on pleading.

. . . .

(b) *How presented.*—Every defense, in law or fact, to a claim for relief

that service of process was insufficient[5] and that the court had therefore failed to acquire in personam jurisdiction.[6] Plaintiff, relying on section 1-75.7 of the North Carolina General Statutes,[7] contended that defendant's right to attack the court's jurisdiction under rule 12(b) had been waived by a voluntary appearance. The trial court rejected plaintiff's argument and ordered dismissal. The decision was affirmed by

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in any pleading, . . . shall be asserted in the responsive pleading thereto if one is required, except that the following defenses may at the option of the pleader be made by motion:

. . . .

(2) Lack of jurisdiction over the person,
(3) Improper venue or division,
(4) Insufficiency of process,
(5) Insufficiency of service of process,

. . . .

A motion making any of these defenses shall be made before pleading if a further pleading is permitted. The consequences of failure to make such a motion shall be as provided in sections (g) and (h). No defense or objection is waived by being joined with one or more other defenses or objections in a responsive pleading or motion . . . .

. . . .

(g) *Consolidation of defenses in motion.*—A party who makes a motion under this rule may join with it any other motions herein provided for and then available to him. If a party makes a motion under this rule but omits therefrom any defense or objection then available to him which this rule permits to be raised by motion, he shall not thereafter make a motion based on the defense or objection so omitted, except a motion as provided in section (h)(2) hereof on any of the grounds there stated.

(h) *Waiver or preservation of certain defenses.*—

(1) A defense of lack of jurisdiction over the person, improper venue, insufficiency of process, or insufficiency of service of process is waived (i) if omitted from a motion in the circumstances described in section (g), or (ii) if it is neither made by motion under this rule nor included in a responsive pleading or an amendment thereof permitted by Rule 15(a) to be made as a matter of course.

5. Upon the hearing of defendant's motion to dismiss, the trial court found that the Buncombe County deputy sheriff who purported to serve the summons upon defendant left the summons and complaint with a security officer employed by a firm under a contract to furnish security services for defendant's property. The officer was neither an employee nor an agent of defendant. She delivered the copy of summons and complaint to the defendant's manager the next morning. The supreme court agreed with the trial and appellate court that service was insufficient under the requirements of rule 4(j)(6), which governs the service of process upon a domestic or foreign corporation. 285 N.C. at 147, 203 S.E.2d at 771.

6. The defendant did not challenge the existence of proper grounds for the assertion of in personam jurisdiction but simply alleged, in effect, that jurisdiction could not be exercised until proper service of process was achieved. A distinction between the mechanical procedures by which jurisdiction is exercised, as involved in *Simms*, and the substantive issue of whether proper grounds *exist* for the exercise of in personam jurisdiction is important in exploring the broader ramifications of *Simms*.

7. Section 1-75.7 is a sub-section of a subchapter on *Jurisdiction*, which was enacted simultaneously with the rules and in pertinent part provides: "A court of this State having jurisdiction of the subject matter *may*, without serving a summons upon him, exercise jurisdiction in an action over a person: (1) who makes a general appearance in an action . . . ." (emphasis added). Section 1-75.2 defines "person" to include "corporation."

the court of appeals,[8] but the plaintiff obtained supreme court review.

Writing for the court, Justice Sharp acknowledged that the pertinent provisions of rule 12(b) were substantially equivalent to their federal rule counterparts and that "under the federal decisions, nothing else appearing, a defendant's motion for an enlargement of time to plead will not waive lack of jurisdiction over the person if the defense is timely presented thereafter in accordance with Rule 12 requirements."[9] However, the court recognized that the issue had to be viewed in light of section 1-75.7 that has no statutory counterpart in federal practice. The court construed section 1-75.7[10] as reflecting a legislative policy decision that "any act which constitutes a general appearance obviates the necessity of service of summons."[11] The court perceived "sound reasons" to support this policy in that

> courts should conserve judicial time and effort by disposing of preliminary defenses relating to personal jurisdiction before considering the merits of a controversy, [and] to allow a party to delay raising the defense of insufficiency of service of process by securing an extension of time to plead may permit the statutes of limitations to bar a claim for relief by a plaintiff who, through no fault of his, is ignorant of the defense.[12]

Consequently, in a decision admittedly inconsistent with federal practice, it held that "by securing an extension of time in which to plead or otherwise answer defendant made a general appearance which rendered the service of summons upon it unnecessary."[13]

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8. 18 N.C. App. 188, 196 S.E.2d 545 (1973).
9. 285 N.C. at 156, 203 S.E.2d at 777.
10. Rule 12 and section 1-75.7 were construed together because they were part of the same enactment. When these statutes were enacted there was a "well established rule" in North Carolina that "a voluntary appearance whereby a defendant obtains an extension of time in which to plead is a *general appearance* which waives any defect in the jurisdiction of the court for want of valid summons or proper service thereof." *Id.* at 157, 203 S.E.2d at 778. The General Assembly was presumed to have used the term "general appearance" in section 1-75.7 in its judicially established meaning "[i]n the absence of anything which clearly indicates a contrary intent . . . ." *Id.* This construction leads to the court's conclusion that the adoption of the rules did not abolish the concept of a general appearance. "On the contrary, . . . Rule 12 eliminated the special appearance and, in lieu thereof, gave a defendant the option of making the defense of lack of jurisdiction over the person by pre-answer motion or by answer even though a defendant makes a general appearance when he files an answer." *Id.* at 157, 203 S.E.2d at 777. But if, before the motion or answer is filed, a defendant engages in conduct that constitutes a general appearance he has "submitted himself to the jurisdiction of the court . . . ." and may not assert the jurisdictional defense "either by motion or answer under Rule 12(b)." *Id.* at 157, 203 S.E.2d at 777-78.
11. *Id.*
12. *Id.* at 157-58, 203 S.E.2d at 777-78.
13. *Id.* at 158, 203 S.E.2d at 778.

Prior to the adoption of the rules, defendant's request for an extension would clearly have constituted a general appearance with the effect of waiving defects in the jurisdiction of the court.[14] The waiver of various defenses by general appearance has had a venerable history in North Carolina,[15] widespread support in other states,[16] and general endorsement in the federal courts before the adoption of the federal rules.[17]

The motivation underlying the original use of the general appearance-waiver doctrine[18] was a desire by courts to overcome the severe territorial due process restrictions on jurisdiction embodied in *Pennoyer v. Neff*.[19] The death knell to the general appearance-waiver doctrine was sounded in the federal courts by the much-quoted case of *Orange Theatre Corp. v. Rayherstz Amusement Corp.*[20] in which the Third Circuit held that federal rule 12 abolished "the age-old distinction between general and special appearances."[21] A year later, the United

14. The previously controlling statutes were both repealed by ch. 954, [1967] N.C. Sess. Laws 1353, the same chapter that enacted the rules. Former section 1-103, 1905 N.C. Rev. Stat. § 447, provided that "[a] voluntary appearance of a defendant is equivalent to personal service of the summons upon him." Former section 1-134.1, ch. 245, [1951] N.C. Sess. Laws 202, eliminated the necessity for special appearances by permitting the objection that the court lacked jurisdiction to be presented either by motion or answer and allowed the making of other motions or the pleading of other defenses simultaneously with the jurisdictional objection but provided that "the making of any motion or the filing of answer prior to the presentation of such objection shall waive it." In the leading case of Youngblood v. Bright, 243 N.C. 599, 91 S.E.2d 559 (1956), the court held that this provision had no application when objection to the court's jurisdiction was not made until after defendant had applied for and obtained an extension of time in which to plead. *Youngblood* stated that "[a] voluntary appearance whereby a defendant obtains an extension of time in which to plead is a general appearance . . . ." and "[a] general appearance waives any defects in the jurisdiction of the court for want of valid summons or of proper service thereof." *Id.* at 602, 91 S.E.2d at 561.

15. *E.g., In re* Blalock, 233 N.C. 493, 64 S.E.2d 848 (1951); Wilson v. Thaggard, 225 N.C. 348, 34 S.E.2d 140 (1945); Moseley v. Deans, 222 N.C. 731, 24 S.E.2d 630 (1943).

16. *E.g.*, Stanley v. Jones, 197 La. 627, 2 So. 2d 45 (1941); United States Fidelity & Guar. Co. v. State, 136 Mont. 148, 345 P.2d 734 (1959). *Contra, e.g.*, Davenport v. Superior Ct., 183 Cal. 506, 191 P. 911 (1920); Bell v. Good, 19 N.Y.S. 693 (City Ct. N.Y. 1892).

17. *E.g.*, Houston v. Ormes, 252 U.S. 469 (1920); Placek v. American Life Ins. Co., 288 F. 987 (W.D. Wash. 1923).

18. *See* Kurland, *The Supreme Court, the Due Process Clause and the In Personam Jurisdiction of State Courts*, 25 U. CHI. L. REV. 569 (1958).

19. 95 U.S. 714 (1877).

20. 139 F.2d 871 (3d Cir. 1944), *cert. denied*, 322 U.S. 740 (1944). A defendant "is no longer required at the door of the federal court house to intone that ancient abracadabra of the law, *de bene esse*, in order by its magic power to enable himself to remain outside even while he steps within." If the defense of lack of jurisdiction is waived, it is "not because of the defendant's voluntary appearance but because of his failure to assert the defense within the time prescribed by [rule 12]." *Id.* at 874.

21. *Id.*

States Supreme Court in *International Shoe Co. v. Washington*[22] eliminated the rationale underlying the general appearance-waiver doctrine. The Court rejected the territorial view of due process, holding that a non-resident defendant could be summoned to a jurisdiction whenever his activities there reasonably justified requiring his presence.[23]

Of course, strict compliance in federal practice with rule 12 will not always protect a defendant against waiver of his objection to jurisdiction of the court.[24] The limitations of *Orange Theatre* are well illustrated in *Wyrough & Loser, Inc. v. Pelmor Laboratories, Inc.*,[25] extensively cited by Justice Sharp.[26] The waiver in *Wyrough*, however, rested not upon the ancient distinction between general and special appearances, but upon a flexible balancing of competing policies on a case-by-case basis to identify situations in which conduct of defendants was sufficiently dilatory or misleading to be inconsistent with the later assertion of a preliminary defense or motion.

Other states that have adopted versions of the federal rules appear to follow the federal practice with respect to the general appearance-waiver doctrine.[27] A comparison of *Simms* with the practice of other

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22. 326 U.S. 310 (1945).

23. *Id.* at 320. *See* Louis, *Modern Statutory Approaches to Service of Process outside the State—Comparing the North Carolina Rules of Civil Procedure with the Uniform Interstate and International Procedure Act*, 49 N.C.L. REV. 235, 236-37 (1971).

24. 2 H. KOOMAN, FEDERAL CIVIL PRACTICE, § 12.23, at 121 (1969).

25. 376 F.2d 543 (3d Cir. 1967). Seven days after defendant received notice of plaintiff's action, the district court began four days of hearings upon the question of issuing a preliminary injunction and these hearings indirectly reached the merits of the controversy. Defendant actively participated without objection to the court's jurisdiction. After issuance of the preliminary injunction but still within the time for answering, defendant filed a motion to dismiss that included the defense of lack of jurisdiction over defendant's person. The court of appeals rejected defendant's reliance upon its earlier decision in *Orange Theatre* in affirming the district court holding that defendant had waived the defense of lack of jurisdiction. The court noted the "countervailing policies" that:

> The whole philosophy behind the Federal Rules militates against placing parties in a procedural strait jacket by requiring them to possibly forego valid defenses by hurried and premature pleading . . . . On the other hand, there also exists a strong policy to conserve judicial time and effort; preliminary matters such as defective service, personal jurisdiction and venue should be raised and disposed of before the court considers the merits or *quasi*-merits of a controversy.

Id. at 547. The court stated that "the process of deciding which is superior must necessarily depend on a *case-by-case* approach" but held in favor of waiver in the instant case because the defendant, having had sufficient time to apprise itself of the jurisdictional questions, should have alerted the court to them. *Id.* at 547 (emphasis added).

26. 285 N.C. at 155-56, 203 S.E.2d at 776-77.

27. Ohio, with civil procedure provisions similar to the federal rules, follows the federal practice despite a prior history of adherence to the general appearance-waiver practice. "'A voluntary appearance does not waive the objection of lack of jurisdiction over the person.'" Browne, *Preserving Objections to In Personam Jurisdiction—Ohio's*

states is difficult, however, because of the influence of section 1-75.7 and because of the paucity of decisions in other states based on similar facts. Nevertheless, one might conclude that support for the *Simms* departure from federal practice is not to be found in the practice of sister states with similar versions of the federal rules.

After the adoption of the North Carolina rules, the North Carolina Court of Appeals, in *Spartan Leasing, Inc. v. Brown*,[28] resolved the general appearance issue in favor of uniformity with the federal practice. Yet, *Simms* did not mention *Spartan Leasing*, in which the appellate court construed section 1-75.7 for the first time[29] and rejected the allegation that a defendant's request for an enlargement of time represented a waiver of objection to jurisdiction. Three appellate cases after *Spartan Leasing* dealt specifically with whether requests for enlargements of time were waivers of lack of jurisdiction for want of either valid service of process or insufficiency of process and followed *Spartan Leasing*.[30] Thus, *Simms* represents a distinct departure from both the federal practice and prior North Carolina cases under the rules.

Limited to its specific holding,[31] the *Simms* decision, on the sur-

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Persistent Shibboleth, 21 CLEV. ST. L. REV., Sept., 1972, 141 at 160, *quoting* W. MILLIGAN, OHIO FORMS OF PRACTICE AND PLEADING 12-18 (1971). Similarly, Note, *Special Appearances Under the Rules of Civil Procedure*, 70 W. VA. L. REV. 64, 73 (1967), contains a well-reasoned prediction, uncontradicted by subsequent decisions, that the previously prevailing practice with respect to special appearance and waiver "should become extinct under the [new] West Virginia Rules."

28. 14 N.C. App. 383, 188 S.E.2d 574 (1972). This case involved a North Carolina corporate plaintiff suing a South Carolina resident for damages under a lease. The summons and complaint were personally served. Defendant secured an enlargement of time and subsequently moved to dismiss, alleging lack of jurisdiction. The trial court rejected plaintiff's general appearance-waiver contention in granting dismissal. The court of appeals affirmed the trial court on this issue but reversed and remanded for a determination of whether alternative statutory grounds existed for the exercise of jurisdiction.

29. The court of appeals in *Spartan Leasing* reasoned that rule 12 governs when rule 12 defenses are waived. Plaintiff's argument that section 1-75.7 revealed a legislative intent to retain the rule that a general appearance waives objection to jurisdiction was expressly rejected by the court, which stated that section 1-75.7

> codifies the long standing rule that a person making a voluntary appearance is *subject to* the court's jurisdiction irrespective of whether jurisdiction over his person has been acquired previously . . . . This statute does not, however, purport to set forth the *time* in which an objection to personal jurisdiction must be made, or *how* the objection is to be waived . . . . Were the right to assert the objection waived in every instance where there was a general appearance, the provisions of Rule 12 . . . would be of no effect.

Id. at 386, 188 S.E.2d at 576 (emphasis added).

30. Philpott v. Kerns, 18 N.C. App. 663, 197 S.E.2d 595 (1973); Simms v. Mason's Stores, Inc., 18 N.C. App. 188, 196 S.E.2d 545 (1973); Williams v. Hartis, 18 N.C. App. 89, 195 S.E.2d 806 (1973).

31. Only a request for an enlargement of time in which to plead or otherwise

face, seems to offer certain advantages. Defendant obviously received actual notice thus achieving the dominant objective of service of process. Permitting subsequent "technical" objections by defendants in such circumstances may realistically be viewed as a procedural luxury that courts with crowded dockets can ill afford. Furthermore, Justice Sharp's concern for the protection of unwary plaintiffs against a statue of limitation bar to an otherwise meritorious claim by a defendant who delays proceedings by a request for an enlargement of time seems laudable.[32]

On the other hand, *Simms* will thwart the objective of achieving uniformity in practice among jurisdictions, a policy that underlies the enactment of "model" legislation such as the federal rules. More importantly, the absoluteness of the holding may have the effect of violating "[t]he whole philosophy behind the Federal Rules [that] militates against placing parties in a procedural strait jacket by requiring them to possibly forgo valid defenses by hurried and premature pleadings."[33]

The balance of pros and cons could legitimately be viewed as in equipoise if analysis terminated at this point. Although the logical validity of the court's construction of section 1-75.7 is not persuasive,[34]

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answer under N.C.R. Civ. P. 6(b) was held to constitute a general appearance, and only lack of jurisdiction for want of valid summons or proper service thereof was waived. 285 N.C. at 158, 203 S.E.2d at 778.

32. *See* text accompanying note 12 *supra*. The apparent significance of this consideration with respect to the court's construction of section 1-75.7 is particularly interesting because plaintiff in *Simms* was not faced with a statute of limitations problem when the defendant moved for dismissal. It appears that defendant's motion for dismissal was filed within thirty days of the 11 August 1971 order allowing an enlargement. The assault for which plaintiff sought recovery allegedly took place on 24 December 1970. The statute of limitations on an action for assault is one year. N.C. GEN. STAT. § 1-54 (1969).

33. Wyrough & Loser, Inc. v. Pelmor Laboratories, Inc., 376 F.2d 543, 547 (3d Cir. 1967). The possibility of violating the philosophy behind the federal rules adds poignancy to Justice Sharp's earlier statement that case law under the rules was examined for "enlightenment and guidance as we develop 'the philosophy of the new rules.'" Sutton v. Duke, 277 N.C. 94, 101, 176 S.E.2d 161, 165 (1970). This orientation toward construction is even more explicit in the general rule stated in Fiske v. Buder, 125 F.2d 841 (8th Cir. 1942). "[W]hen a statute is adopted from another jurisdiction, in substantially the same language, the provisions so adopted are to be construed in the sense in which they were understood at the time in the jurisdiction from which they were taken." *Id.* at 844.

34. *See* note 10 *supra*. The court did not discuss the legislative use of the permissive word "*may*" in section 1-75.7 in relation to the more explicit direction of rule 12(b) that "every defense . . . *shall* be asserted in the responsive pleading . . . except that the following defense may *at the option of the pleader* be made by motion . . . ." N.C.R. Civ. P. 12(b) (emphasis added). Consideration of these provisions may have provided a "clear indication" of the sense in which "general appearance" was used in

the result achieved in this particular factual context[35] seems desirable. Once the impact of this decision is widely disseminated, however, its apparent advantages may be largely illusory. For example, a defendant desirous of lulling a plaintiff into inaction until a statute of limitations expired could file an answer containing all the rule 12 motions stated in very general terms. This ploy would avoid waiver but still would accomplish the "evil" at which *Simms* was directed—plaintiff effectively would be deprived of notice of the specific grounds upon which the objecton to jurisdiction were based. Common sense also suggests that attorneys actually in need of an extension of time will

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section 1-75.7. In this regard the construction of section 1-75.7 by the court of appeals is a much more probable expression of legislative intent. *See* note 29 *supra.*

35. *Simms,* however, has not been limited to this particular factual context. Philpott v. Kerns, 285 N.C. 225, 203 S.E.2d 778 (1974), decided contemporaneously with *Simms,* involved an out of state motorist defendant upon whom patently defective summons had been served. After securing an enlargement of time, the defendant moved for dismissal, alleging lack of jurisdiction for want of sufficiency of process. The trial court dismissed and the court of appeals affirmed. Philpott v. Kerns, 18 N.C. App. 663, 197 S.E.2d 595 (1973). The supreme court summarily reversed, relying on *Simms,* without any discussion of the potential complications introduced in the *Philpott* case by the out of state status of the defendant.

Philpott illustrates a substantial question raised by the language in *Simms.* Justice Sharp construed rule 12 as allowing an exception to waiver of jurisdiction over the person by the filing of an answer. 285 N.C. at 157, 203 S.E.2d at 777. This construction could imply that other pre-rules forms of general appearance not specifically "saved" by rule 12 such as acceptance of service of process, entering appearance of record, or any other overt act which will constitute a general appearance, would have the same effect as the request for an enlargement of time had in *Simms.* Similarly, the court discussed language from other decisions related to the raising of "preliminary matters such as defective service, personal jurisdiction, and venue . . . ." that might suggest a willingness to extend the scope of the general appearance waiver far beyond the limited scope of sufficiency of process and sufficiency of service revealed in *Philpott* and *Simms. Id.* at 155, 203 S.E.2d at 776.

The possibility of an expansion of *Simms* was soon confirmed. In *Spartan Leasing* the trial court on remand again dismissed plaintiff's action after finding insufficient minimum contacts by defendant with North Carolina to establish in personam jurisdiction. The court of appeals again confirmed. 19 N.C. App. 295, 198 S.E.2d 583 (1973). Upon certiorari the supreme court, again unanimously (with Chief Justice Bobbitt not sitting) reversed. 285 N.C. 689, 208 S.E.2d 649 (1974). Justice Branch quoted *Simms* and then stated: "In light of the holding in *Simms,* it is not necessary to consider the question of whether defendant had minimum contacts . . . to confer jurisdiction upon the Courts of this State. Under that holding defendant clearly became subject to the jurisdiction of the North Carolina courts when he obtained an extension of time to answer or otherwise plead." *Id.* at 699, 208 S.E.2d at 656. Thus, without any balancing of countervailing considerations, the *Simms* waiver has been extended from service or sufficiency of process to the actual existence of personal jurisdiction, even in the face of a determination by the lower courts that defendant lacked sufficient minimum contact with North Carolina otherwise to justify requiring him to defend in this state. This and other potential expansions of *Simms* present several complex and troublesome issues beyond the scope of this note. The limits of such expansion may well be tested, however, by a due process challenge raised by an out-of-state defendant through either direct or collateral attack upon a judgment secured by a North Carolina plaintiff.

first defensively file a *pro forma* rule 12 motion. This motion, which may be based on superficial analysis, will undoubtedly include all defenses and objections that might otherwise be waived, limited only by the certification required by rule 11.[36] Consequently, the only "judicial time and energy" conserved will probably be at the expense of an occasional unwary defendant who does not realize that rule 12 no longer means what it seems to say.[37] Paradoxically, *Simms* may actually *waste* judicial time and energy through hearings on preliminary motions that would not have been filed had the pleader been able to utilize the extension of time granted for a more thorough analysis of the merits of the preliminary motions.[38]

If the legal community adjusts itself to *Simms* as suggested above, the "unwary plaintiff" will at least know what defenses have been put forth before the extension of time is granted and thus have an opportunity to protect himself against a possible interim statute of limitations bar. There are, however, other alternatives available to a plaintiff and the court for providing the desired protection that achieve the *Simms* objective of conserving judicial time without the disadvantages discussed above.[39] The plaintiff, for example, when confronted with a soundly based motion for dismissal could take a voluntary dismissal by giving notice under rule 41(a)(1)(i) and gain up to an additional year under the applicable statute of limitations.[40] Similarly, the court could

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36. The pressure placed on an attorney in this situation may well lead to an undesirable "stretching" of the already cloudy "good grounds to support" certification of N.C.R. Civ. P. 11.

37. The "surprise" consequence of *Simms* will be particularly adverse to out-of-state defendants not conversant with the North Carolina rules who routinely request an enlargement of time to facilitate the remediation of their uninformed status.

38. Of course, defenses and objections revealed by closer examination to be totally without merit will undoubtedly be withdrawn prior to hearing.

39. *See* text accompanying notes 33-38 *supra*.

40. (a) *Voluntary Dismissal; effect thereof.*—
(1) By Plaintiff; by Stipulation.—Subject to the provisions of Rule 23(c) and of any statute of this State, an action or any claim therein may be dismissed by the plaintiff without order of the court (i) by filing a notice of dismissal at any time before the plaintiff rests his case, or; (ii) . . . If an action commenced within the time prescribed therefor . . . is dismissed without prejudice under this subsection, a new action based on the same claim may be commenced within one year after such dismissal unless . . . .

N.C.R. Civ. P. 41(a)(1). *See* Cutts v. Casey, 278 N.C. 390, 180 S.E.2d 297 (1971). This procedure may be used only once and has the disadvantage under rule 41(d) of plaintiff being taxed with the costs of the action up to the point of dismissal.

Another possible problem related to the use of rule 41(a) is revealed by the decision in Hodges v. Home Ins. Co., 233 N.C. 289, 63 S.E.2d 819 (1951), which held, in interpreting a predecessor statute, that a second action commenced within the extended period was barred when the first action was dismissed for want of service of

order a voluntary dismissal under rule 41(a)(2) with the same effect upon the statute of limitations.[41] This procedure would allow the trial court judge to exercise discretion in protecting unwary plaintiffs from a statute of limitations bar.[42]

Perhaps a more direct and effective procedure would be the issuance of additional summons or the amendment of process through utilization of rules 4(a)[43] and (i).[44] Although these provisions have been largely ignored[45] in North Carolina, federal practice reveals precedent for utilizing rule 4(a) for the granting of an additional summons to cure defects in the service of a prior summons.[46] There is similarly ample support in federal practice for the position that an amendment of process (with respect to insufficiency of process) under rule 4(h) [4(i) under the North Carolina rules] shall be freely granted and that when granted the amendment relates back so that the action is not barred by the expiration of the statute of limitations between the time of service and the time of amendment.[47] In *C.J. Wieland & Son Dairy Prod-*

process. In Gower v. Aetna Ins. Co., 281 N.C. 577, 189 S.E.2d 165 (1972), however, there is a strong inference that this limitation will not be imposed on actions under rule 41(a) or (b).

41. (a) *Voluntary Dismissal; effect thereof.*—

> . . . .
>
> (2) By Order of Judge.—Except as provided in subsection (1) of this section, an action or any claim therein shall not be dismissed at the plaintiff's instance save upon order of the judge and upon such terms and conditions as justice requires. Unless otherwise specified in the order, a dismissal under this subsection is without prejudice. If an action commenced within the time prescribed therefor, or any claim therein, is dismissed without prejudice under this subsection, a new action based on the same claim may be commenced within one year after such dismissal unless the judge shall specify in his order a shorter time.

N.C.R. Civ. P. 41(a)(2).

42. "The obvious purpose of Rule 41(a)(2) is to permit a superior court judge in the exercise of his discretion to dismiss an action without prejudice if in his opinion an adverse judgment with prejudice would defeat justice." King v. Lee, 279 N.C. 100, 107, 181 S.E.2d 400, 404 (1971).

43. "[U]pon request of the plaintiff separate or additional summons shall be issued against any defendants." N.C.R. Civ. P. 4(a).

44. "At any time, before or after judgment, in its discretion and upon such terms as it deems just, the court may allow any process or proof of service thereof to be amended, unless it clearly appears that material prejudice would result to substantial rights of the party against whom the process issued." *Id.* 4(i); Fed. R. Civ. P. 4(h).

45. The North Carolina Supreme Court has construed rule 4(a) only once. Sink v. Easter, 284 N.C. 555, 202 S.E.2d 138 (1974). *Sink* did not concern the provision of 4(a) considered here. The supreme court has not yet construed 4(i), and only one court of appeals decision has dealt with 4(i) in perfunctorily concluding, without discussion, that an amendment of process would "prejudice substantial rights of the defendants." Philpott v. Kerns, 18 N.C. App. 663, 665, 197 S.E.2d 595, 596 (1973).

46. Grammenos v. Lemos, 457 F.2d 1067 (2d Cir. 1972); 4 C. Wright & A. Miller, Federal Practice & Procedure, § 1085, at 340 n.67 (1969).

47. *See* Metropolitan Paving Co. v. International Union of Operating Eng'rs, 439

ucts Co. v. Wickard,[48] commented upon with approval by Professors Wright and Miller,[49] the court granted an amendment under rule 4(h) even though the defect was in the manner of service rather than in the documents themselves.

Adoption of these approaches in the use of rule 4(a) and (i) would provide plaintiffs with statute of limitations protection and avoid "material prejudice to substantial rights" of defendants. Additionally, judicial time and energy would be conserved by, in effect, rendering futile technical and non-substantive objections to lack of valid summons or insufficiency of service thereof by defendants who had received actual notice of pendency of a suit.

Simms seems to have been motivated by the realistic objectives of conserving judicial time and protecting unwary plaintiffs. On the narrow facts of that case, these objectives were achieved, but at the expense of a violation of the philosophy behind the Rules of Civil Procedure under which North Carolina operates. On a broader scale, the achievement of conserving judicial time by the *Simms* general appearance-waiver approach is questionable. There are more effective alternatives available to the court for the conservation of judicial time that will also protect plaintiffs from a statute of limitations bar in the occasional situation where such protection is needed. The acceptance of these preferred alternatives would provide a sound basis for either reconsidering *Simms* or narrowly restricting its scope. Such restriction could be accomplished by holding *Simms* applicable only when there were no other means available to protect a plaintiff from a statute of limitations bar interposed by a defendant who objected to service or sufficiency of process after obtaining an extension of time. Hopefully, the resurrection of the general appearance-waiver doctrine will be short lived.

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F.2d 300 (10th Cir. 1947); United States v. A.H. Fischer Lumber Co., 162 F.2d 872 (4th Cir. 1947). *See generally* 4 C. WRIGHT & A. MILLER, *supra* note 46, §§ 1131-32 at 547-53.

48. 4 F.R.D. 250 (E.D. Wis. 1945).

49. "This decision seems to go a step beyond the correction of a misnomer or technical defect but nevertheless seems correct since the basic requisite of giving notice of the suit before the running of the statute was met." 4 C. WRIGHT & A. MILLER, *supra* note 46, § 1131 at 552 n.2.

Criminal Law—North Carolina's Sodomy Statute: A Need For Revision

More than two decades have passed since the publication of Alfred Kinsey's study on human sexual behavior that made clear the wide disparity between conservative sexual behavior permitted by law and the liberal sexual practices that Kinsey found actually to occur in society. Dr. Kinsey stated that " '[s]ex laws are so far at variance with general sex practices that they could not conceivably be rigorously enforced.' "[1]

The North Carolina sodomy statute is an example of an antiquated law in need of reform.[2] The statute provides that "[i]f any person shall commit the crime against nature, with mankind or beast, he shall be guilty of a felony, and shall be fined or imprisoned in the discretion of the court."[3] In light of recent state and federal court decisions concerning the void-for-vagueness and right to privacy concepts,[4] the statute is vulnerable to constitutional attack.

VOID-FOR-VAGUENESS

The North Carolina sodomy statute contains the terminology "the crime against nature," and "with mankind or beast." This language tells the citizen nothing about the nature of the crime prohibited by the statute, nor does it define those persons who come within the purview of the statute. According to the United States Supreme Court:

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1. Burling, Book Review, 23 N.Y.U.L.Q. REV. 540, 541 (1948), *quoting* A. KINSEY, SEXUAL BEHAVIOR IN THE HUMAN MALE (1948).

2. A few jurisdictions have already updated their statutes in response to the need for change. E.g., ILL. REV. STAT. ch. 38, art. 11-2 (1962); N.Y. PENAL LAW § 130.00 (1967). These states have made recent changes in their sodomy statutes to exclude sexual conduct by consenting married adults carried out in private. Kansas, Connecticut, and Minnesota have repealed their sodomy statutes. Approximately one-half of the states have statutes that, like North Carolina's, remain antiquated. W. Barnett, SEXUAL FREEDOM AND THE CONSTITUTION 23 (1973).

3. N.C. GEN. STAT. § 14-177 (1969).

4. This note will discuss only the "void-for-vagueness" and the general right to privacy arguments because they seem most pertinent to North Carolina's sodomy statute. Other arguments include (i) cruel and unusual punishment, *see* Note, *Sodomy Statutes—A Need for Change*, 13 S.D.L. REV. 384, 394-95 (1968), which analogizes Robinson v. California, 370 U.S. 660 (1962), to sodomy cases in which a person may carry the "status" of a homosexual; (ii) establishment of religion principle, *see* D. BAILEY, HOMOSEXUALITY AND THE WESTERN CHRISTIAN TRADITIONS 33, 58, 64-70 (1955), in which it is contended that sodomy is a crime according to the Bible and Judeo-Christian tradition, and therefore, sodomy statutes violate the establishment clause of the first amendment; and (iii) equal protection of the law, *see* W. BARNETT, SEXUAL FREEDOM AND THE CONSTITUTION 260-68 (1973), which concerns the discrimination shown by the enforcement of sodomy statutes against unmarried persons and male homosexuals more often than against married persons or female homosexuals.

> [A] law fails to meet the requirements of the Due Process Clause if it is so vague and standardless that it leaves the public uncertain as to the conduct it prohibits or leaves judges and jurors free to decide, without any legally fixed standards, what is prohibited and what is not in each particular case.[5]

A myriad of cases have held that the due process clauses of the fifth and fourteenth amendments are violated by statutes drawn so vaguely that they fail to give clear warning to citizens.[6] In short, a law must be understandable or it is no law at all.[7]

The North Carolina sodomy statute has its roots in the original English sodomy statute dating from 1533 that addressed the "detestable and abominable vice of buggery committed with mankind or beast."[8] In England the term "buggery" was interpreted to include both sodomy and bestiality.[9] Under the common law, bestiality was generally understood to mean carnal copulation between man and animal, and the term "sodomy" had its basis in the biblical story of Sodom and Gomorrah where sexual acts between man and man *per anum*[10] were believed to have been prevalent.[11] A case in England in 1817[12] set the precedent for the definition of sodomy in law to mean acts *per anum* and not acts *per os*.[13]

The North Carolina legislature adopted the English sodomy statute in 1837, but substituted for "the vice of buggery" the phraseology "the crime against nature."[14] The exact nature of the act involved caused a reluctance to require a detailed description in the statute. Consequently, when the formulators of the law sought to describe sodomy in moral terms rather than to define it as a crime, the language of the statute necessarily became vague. While the

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5. Giaccio v. Pennsylvania, 383 U.S. 399, 402-03 (1966).

6. *E.g.*, Raley v. Ohio, 360 U.S. 423 (1959); Lanzetta v. New Jersey, 306 U.S. 451 (1939); Connally v. General Constr. Co., 269 U.S. 385 (1926).

7. The ancient maxim *ubi jus incertum, ibi jus nullum* has been passed down through common law.

8. Stat., 25 Hen. 8 c. 6 (1533).

9. Ausman v. Veal, 10 Ind. 355 (1858).

10. "By or through the anus." STEDMAN'S MEDICAL DICTIONARY 1132 (lawyers ed. 1961).

11. *Genesis* 19:5-8, 24-26.

12. Rex v. Jacobs, 168 Eng. Rep. 830 (Cr. Cas. Res. 1817).

13. "By or through the mouth." STEDMAN'S MEDICAL DICTIONARY 1140 (lawyers ed. 1961).

14. "Any person who shall commit the abominable and detestable crime against nature, not to be named among Christians, with either mankind or beast, shall be adjudged guilty of a felony, and shall suffer death without the benefit of clergy." N.C. Rev. Stat. c. 34, § 6 (1837).

term "buggery" had a precise definition at common law, a 1914 North Carolina Supreme Court decision[15] held that, since the statute did not use the specific word "sodomy," the phrase "the crime against nature" must be broader than "sodomy" and included acts *per os*.[16] The breadth of the North Carolina sodomy statute was established through the courts' broad interpretation of legislative intention, changing English terminology, and extending precedents.[17] Given the courts' expansive interpretation, the statute fails to protect the citizen whose only warning of behavior proscribed by the North Carolina sodomy statute must come from his understanding of the ambiguous phrase "the crime against nature."

In 1964 the validity of the North Carolina sodomy statute was challenged for vagueness. In *Perkins v. North Carolina*[18] a case involving two homosexuals charged with oral copulation, a federal district court upheld the statute, while at the same time admitting that "[i]f the statute were a new one, it would be obviously unconstitutional for vagueness. The former concern for the feelings of those reading the statute has yielded to the necessity that an indicted person know of what he is charged. Euphemisms have no place in criminal statutes."[19] In an attempt to rectify this apparent incongruity, the court stated that prior judicial interpretations of the statute's meaning remedied its vagueness.[20] *Perkins*, by acknowledging vagueness, has added impetus to a void-for-vagueness attack.

Significantly, in *Franklin v. State*,[21] a Florida court had to determine the validity of a sodomy statute that was virtually identical to

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15. State v. Fenner, 166 N.C. 247, 80 S.E. 970 (1914). A few years later in State v. Griffin, 175 N.C. 767, 94 S.E. 678 (1917), the court commented on the legislative intent behind the North Carolina sodomy statute by stating: "[O]ur statute is broad enough to include in the crime against nature other forms of the offenses than sodomy and buggery. It includes all kindred acts of a bestial nature whereby degraded and perverted sexual desires are sought to be gratified." *Id.* at 769, 94 S.E. at 679.

16. As precedent, the court cited Herring v. State, 119 Ga. 709, 46 S.E. 876 (1904). *Herring* held that the Georgia sodomy statute included both acts *per anum* and *per os*, ignoring Rex v. Jacobs, 168 Eng. Rep. 830 (Cr. Cas. Res. 1817) (sodomy defined as acts *per anum*).

17. State v. Walston, 259 N.C. 385, 130 S.E.2d 636 (1963) (per curiam); State v. Williams, 247 N.C. 272, 100 S.E.2d 500 (1957) (per curiam); State v. Griffin, 175 N.C. 767, 94 S.E. 678 (1917); State v. Fenner, 166 N.C. 247, 80 S.E. 970 (1914). *See also* Perkins v. North Carolina, 234 F. Supp. 333, 336 n.8 (W.D.N.C. 1964).

18. 234 F. Supp. 333 (W.D.N.C. 1964).

19. *Id.* at 336.

20. *Id.*

21. 257 So. 2d 21 (Fla. 1971) (per curiam).

that of North Carolina.[22] Two individuals were observed committing a "crime against nature."[23] The Florida Supreme Court held the statute "void on its face as unconstitutional for vagueness and uncertainty in the language, violating constitutional due process of the defendants."[24] Following the precedent set in *Franklin*, the North Carolina statute would probably succumb to another constitutional attack on its vagueness.

RIGHT TO PRIVACY

The North Carolina sodomy statute is also subject to attack as being violative of the constitutionally protected right to privacy established in *Griswold v. Connecticut*.[25] The United States Supreme Court reversed convictions under a Connecticut statute[26] prohibiting the use of contraceptives, holding that the statute violated the general right to privacy by attempting to regulate and control acts within the marriage relationship. Justice Douglas, in the majority opinion, stressed the fundamental importance of marital privacy. "We deal with a right older than the Bill of Rights, older than our political parties, older than our school system. Marriage is a coming together for better or for worse, hopefully enduring, and intimate to the degree of being sacred."[27] Even a narrow interpretation of *Griswold* compels acknowledgment of a constitutional right of marital privacy that comes within the "penumbras" of the first, third, fourth, fifth and ninth amendments and that is protected against state interference by the fourteenth amendment.[28] If *Griswold* protects married couples from state prohibition of acts that express marital love but prevent unwanted children, then, arguably, *all* private consensual sexual acts of married persons should be similarly protected.

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22. "Whoever commits the abominable and detestable crime against nature, either with mankind or with beast, shall be punished by imprisonment in the state prison not exceeding twenty years." Ch. 1637, subc. 8, § 17, [1868] FLA. LAWS 98 (repealed 1974).

23. The record of the case did not reveal what activities were observed by the policeman.

24. 257 So. 2d at 24. *Franklin* was effective prospectively only. In Stone v. Wainwright, 478 F.2d 390, 397 (5th Cir. 1973), a federal court struck down the Florida sodomy statute both prospectively and retroactively as unconstitutionally vague.

25. 381 U.S. 479 (1965).

26. CONN. GEN. STAT. REV. §§ 53-32, 54-196 (1958).

27. 381 U.S. at 486.

28. *Id.* at 483-85. Also note that the fifth amendment gives the same protection against federal invasion.

Cases following *Griswold* appear to have accepted this broadened interpretation as applied to sodomy statutes. First, in *Cotner v. Henry*,[29] defendant had been convicted of sodomy with his wife. The petitioners used the *Griswold* decision as a defense against application of the state sodomy statute to married persons. While the Seventh Circuit did not declare the Indiana sodomy statute unconstitutional, it suggested that the Indiana courts should construe the statute to exclude private sexual acts between consenting married persons.[30] *Cotner* stated that "the import of the *Griswold* decision is that private, consensual, marital relations are protected from regulation by the state through the use of a criminal penalty."[31]

Buchanan v. Batchelor,[32] a federal district court case, went a step beyond *Cotner*. The petitioner had been arrested and charged with sodomy upon another individual in a public restroom in Dallas. Michael and Janet Gibson, a married couple, intervened, alleging that the defendant did not represent the interests of married persons subject to prosecution under the Texas sodomy statute.[33] The court ruled that under *Griswold* the Texas statute was void *on its face*[34] for unconstitutional overbreadth—the wording allowed prosecution of persons engaging in acts within the privacy of the marriage relationship.

The above cases indicate the development of a trend that demands a broadening of the scope of activities afforded constitutional protection under the right to privacy. *Stanley v. Georgia*[35] provides a basis for extending this right beyong the marital relationship to encompass the activities of unmarried individuals. The defendant in *Stanley* was charged with having in his possession certain materials that were deemed indecent or obscene. The materials had been discovered during a search of the defendant's home conducted under a warrant issued for evidence of bookmaking activity. Voicing the opinion of the Court, Justice Marshall stated:

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29. 394 F.2d 873 (7th Cir.), *cert. denied*, 393 U.S. 847 (1968).
30. *Id.* at 875.
31. *Id.*
32. 308 F. Supp. 729 (N.D. Tex. 1970), *vacated sub nom.* Wade v. Buchanan, 401 U.S. 989 (1971) (mem.).
33. TEX. PENAL CODE art. 524 (1952).
34. The significance of *Buchanan* is twofold. The case affirmed the constitutional protection of private consensual sexual expression by married persons and, while the judgment was later vacated for lack of standing on appeals to the Supreme Court, a Texas court has never since denied such protection to married persons.
35. 394 U.S. 557 (1969).

> The makers of our Constitution undertook to secure conditions favorable to the pursuit of happiness. They recognized the significance of a man's spiritual nature, of his feelings and of his intellect. They knew that only a part of the pain, pleasure and satisfactions of life are to be found in material things. They sought to protect Americans in their beliefs, their thoughts, their emotions and their sensations. They conferred, as against the Government, the right to be let alone—the most comprehensive of rights and the rights most valued by civilized man."[36]

Eisenstadt v. Baird[37] continued the extension of the *Griswold* privacy protection to single persons. In *Eisenstadt*, a case which arose from a violation of the Massachusetts statute prohibiting the distribution of contraceptives to unmarried persons, the Supreme Court held:

> If under *Griswold* the distribution of contraceptives to married persons cannot be prohibited, a ban on distribution to unmarried persons would be equally impermissible. It is true that in *Griswold* the right to privacy in question inhered in the marital relationship. Yet the marital couple is not an independent entity with a mind and heart of its own, but an association of two individuals each with a separate intellectual and emotional makeup. If the right of privacy means anything, it is the right of the *individual*, married or single, to be free from unwarranted governmental intrusion into matters so fundamentally affecting a person as the decision whether to bear or beget a child.[38]

If *Griswold* can be interpreted to protect married couples from enforcement of statutes that violate their right to privacy, *Eisenstadt* would seem to compel the same protection for single persons.

CONCLUSION

A new sodomy statute for North Carolina should be enacted that would eliminate vagueness and possible violations of the general right to privacy. The statute should protect citizens from harm and disturbing public conduct, yet reflect a modern tone by restraining itself to considerations within the law, leaving individual morality to individual conscience. Such a statute might read:[39]

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36. *Id.* at 564, *quoting* Olmstead v. United States, 277 U.S. 438, 478 (1928) (Brandeis, J. Dissenting).

37. 405 U.S. 438 (1972).

38. *Id.* at 453.

39. This statute was modeled after several recently redrafted state statutes as well as the Model Penal Code. *See* CONN. GEN. STAT. ANN. § 53A-65 (Supp. 1969); ILL. REV. STAT. ch. 38, §§ 11-2 to -5 (1962); N.Y. PENAL LAW § 130.40 (1967); MODEL PENAL CODE § 207.5.

§ 14-177. Deviate Sexual Behavior

(A) "Deviate Sexual Behavior" means

(1) any wilful act of sexual contact between any person, consisting of contact between the penis and the anus, the mouth and the penis, the mouth and the vulva, the mouth and the anus, or

(2) any form of sexual conduct with an animal.

(B) Deviate Sexual Behavior is committed only when:

(1) it is perpetrated with force or threat of force, or when any person compels any other person to perform such acts of deviate sexual behavior;

(2) it is perpetrated upon any person under the age of sixteen or any mentally incompetent person regardless of age;

(3) it is perpetrated in any place where the conduct may reasonably be expected to be viewed by others.

(C) Any person found guilty of committing an offense under this statute shall be deemed guilty of a felony.

JOHN PARKER HUGGARD

Damages—Retail Prices for Damaged Goods—A Double Recovery?

In *Kaplan v. City of Winston-Salem*[1] the North Carolina Supreme Court recently opened the door for recovery of the retail value of goods damaged while awaiting sale. In so doing, the court differed with the majority of jurisdictions that have ruled on this issue and apparently overlooked several significant deficiencies in such a measure of damages.

In 1966 the City of Winston-Salem replaced the sidewalk in front of a toy store operated by Leon and Renee Kaplan. Pieces of the old sidewalk dropped into a vault below the sidewalk, causing dust and debris to permeate the store, permanently damaging many of the toys.[2] The trial court judge instructed the jury that, should damages be awarded, their measure would be "the difference

1. 286 N.C. 80, 209 S.E.2d 743 (1974).
2. *Id.* at 80-81, 209 S.E.2d at 743-45; Record at 1-2, 7, 22, 40-43.

in the reasonable market value of the merchandise before and after it was damaged."[3] After first defining "reasonable market value" to be "the amount which, the owner . . . would accept for it and . . . a buyer . . . would pay for it," the trial judge added:

> [Y]ou may, in arriving at the fair market value of the items, take into consideration the replacement cost of the items which would be the wholesale price of the goods. You may consider but are not bound by the retail prices of the damaged items because that price would include profits which may or may not be realized and therefore would be a speculative value.[4]

The jury found defendant negligent and awarded damages to plaintiffs.[5] The North Carolina Court of Appeals found the judge's instruction erroneous and granted a new trial,[6] but the Supreme Court of North Carolina reversed, holding that the trial judge's instruction was correct.[7] The court based its conclusion upon the principle, enun-

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3. 286 N.C. at 82, 85, 209 S.E.2d at 745, 747; Record at 90.

4. 286 N.C. at 82-83, 85-86, 209 S.E.2d at 745, 747; Record at 90-91. The full text of this portion of the instructions was as follows:

> In the event you have reached this issue and find by the greater weight of the evidence that the plaintiffs are entitled to recover of the defendant for damages to the plaintiffs' merchandise, I instruct you that you will take into consideration the description of and the evidence of the damages to the merchandise which the witnesses have given you. You may consider for the purpose of illustrating the testimony of the witnesses the pictures that you have seen of the merchandise and you will award to the plaintiffs, if you award anything on this issue, the amount which you find represents the difference in the reasonable market value of the merchandise before and after it was damaged. The reasonable market value of any article being the amount which, the owner wanting to sell but not having to, would accept for it and the amount which a buyer who wanted the article but didn't have to have it would pay for it in a free, fair trade in which there is no compulsion on either side. In this case, that amount may be anywhere from one cent to forty-nine thousand nine hundred and seven dollars and seven cents.
>
> Now, in a case of this type involving the stock of merchandise, you may, in arriving at the fair market value of the items, take into consideration the replacement cost of the items which would be the wholesale price of the goods. You may consider but are not bound by the retail prices of the damaged items because that price would include profits which may or may not be realized and therefore would be a speculative value. In considering the cost of the merchandise to the plaintiff, you may also consider reasonable delivery charges and unpacking expenses involved in the goods or merchandise reaching the stage at which they were at the time that this damage was done to it. In other words, you will try by your verdict to put the plaintiffs in the same position they were in prior to the damage to their merchandise insofar as money can do so. If you reach this issue and decide the plaintiffs are entitled to recover anything as a result of the actionable negligence of the defendant, you will award them the amount you find will fully compensate them for their loss according to the rules I have given you with regard to damages in this kind of a case and you will base your verdict on the evidence in the case.

Id.

5. 286 N.C. at 81, 209 S.E.2d at 745; Record at 93.

6. 21 N.C. App. 168, 172-73, 203 S.E.2d 653, 656-57 (1974).

7. 286 N.C. 80, 83, 209 S.E.2d 743, 746 (1974).

ciated in earlier North Carolina cases, that "the measure of damages [for injury to personal property] is the difference between the market value . . . immediately before and immediately after the injury."[8] Unfortunately, the court overlooked the ramifications of its approval of the trial judge's instructions. Justice Sharp pointed out this oversight in her dissent, in which she stated that, when the damage is to a stock of goods held for sale, the measure of damages should be the wholesale value less the salvage value and that the judge's instructions allowed the jury to measure the damages according to retail value, which included the "profit of resale."[9]

Few cases in North Carolina have considered the value of a seller's stock of goods for purposes of measuring the damages incurred as a result of injury to such goods. In *Jones v. Call*,[10] in which a manufacturer was forced to cease production, the court held that the measure of damages would be limited to loss of profits on existing orders and could not include loss of profits on other predicted sales. In *Johnson v. Railroad Co.*[11] defendant negligently caused the burning of plaintiff's crates and baskets that were for sale, and plaintiff was unable to replace the material from which these were made. The court allowed recovery of anticipated profits only to the extent of sales from existing contracts and disallowed, as "speculative," profits not represented by existing contracts.[12] In other cases, goods have been denied a retail seller through breach of contract.[13] There, profits were recoverable, but only when the retail seller was unable to obtain replacements from other suppliers, and then only to the extent that evidence of profit from past sales[14] or actual demand[15] was

8. *Id., citing* Carolina Power & Light Co. v. Paul, 261 N.C. 710, 136 S.E.2d 103 (1964); United States Fidelity & Guaranty Co. v. P. & F. Motor Express, Inc., 220 N.C. 721, 18 S.E.2d 116 (1942); West Constr. Co. v. Atlantic Coast Line Ry., 185 N.C. 43, 116 S.E. 3 (1923).

9. 286 N.C. at 86-89, 209 S.E.2d at 747-49.

10. 96 N.C. 337, 2 S.E. 647 (1887).

11. 140 N.C. 574, 53 S.E. 362 (1906).

12. In Hart v. Atlantic Coast Line R.R., 144 N.C. 91, 56 S.E. 559 (1907), the court said that the measure of damages where cord-wood was destroyed by sparks from defendant's engine was the value of the wood in the locality where it was damaged, and not the value of the wood standing in the woods plus the cost of cutting. However, there was no evidence that plaintiff was in the business of selling wood.

13. Davidson Hardware Co. v. Delker Buggy Co., 167 N.C. 423, 83 S.E. 557 (1914); American Steel & Wire Co. v. Copeland, 159 N.C. 556, 75 S.E. 1002 (1912).

14. Davidson Hardware Co. v. Delker Buggy Co., 167 N.C. 423, 83 S.E. 557 (1914).

15. American Steel & Wire Co. v. Copeland, 159 N.C. 556, 559, 75 S.E. 1002, 1003 (1912).

presented. Furthermore, in cases involving injuries not caused by damage to or withholding of the seller's stock of goods, the North Carolina courts have moved toward allowing profits when shown to be probable. Recovery has been allowed for profit loss that resulted from loss of a motor vehicle,[16] from personal injury,[17] or from loss of customers caused by unclean water coming through the ceiling of a restaurant.[18]

A common thread running through most of these cases is plaintiff's inability to mitigate damages. Consequently, the supreme court has stated that a plaintiff may not recover damages for loss of profits resulting from loss of use of a vehicle if he fails to show that he made a reasonable but unsuccessful effort to obtain a substitute.[19] Furthermore, the North Carolina courts have continued to deny recovery for lost profits that are too speculative.[20]

The issue of whether a retail seller should be allowed to recover the retail value or the wholesale value for his damaged or destroyed merchandise has been discussed in detail by courts in a small number of jurisdictions.[21] In circumstances similar to *Kaplan*, these cases have specifically declined to measure damages in terms of retail value,[22] except in one case in which the goods were antiques.[23] Numerous

16. Overnite Transp. Co. v. International Bhd. of Teamsters, 257 N.C. 18, 125 S.E.2d 277 (1962); Reliable Trucking Co. v. Payne, 233 N.C. 637, 65 S.E.2d 132 (1951); Binder v. General Motors Acceptance Corp., 222 N.C. 512, 23 S.E.2d 894 (1943); Wilson v. Horton Motor Lines, Inc., 207 N.C. 263, 176 S.E. 750 (1934).

17. Jernigan v. Atlantic Coast Line R.R., 12 N.C. App. 241, 182 S.E.2d 847 (1971).

18. Steffan v. Meiselman, 223 N.C. 154, 25 S.E.2d 626 (1943).

19. Roberts v. Pilot Freight Carriers, Inc., 273 N.C. 600, 607-08, 160 S.E.2d 712, 718 (1968).

20. Meares v. Nixon Constr. Co., 7 N.C. App. 614, 173 S.E.2d 593 (1970); Bradley v. Texaco, Inc., 7 N.C. App. 300, 172 S.E.2d 87 (1970).

21. *See* cases cited note 22 *infra*. One court has stated, "There are comparatively few cases in other states determinative of this question." Chicago Title & Trust Co. v. W.T. Grant Co., 2 Ill. App. 3d 483, 486, 275 N.E.2d 670, 673 (1971).

22. Whaley v. Crutchfield, 226 Ark. 921, 294 S.W.2d 775 (1956); Skaggs Drug Centers, Inc. v. City of Idaho Falls, 90 Idaho 1, 407 P.2d 695 (1965); Sears v. Lydon, 5 Idaho 358, 49 P. 122 (1897); Chicago Title & Trust Co. v. W.T. Grant Co., 2 Ill. App. 3d 483, 275 N.E.2d 670 (1971); Lubin v. City of Iowa City, 257 Iowa 383, 131 N.W.2d 765 (1964); International Harvester Co. v. Chicago, M. & St. P. Ry., 186 Iowa 86, 172 N.W. 471 (1919); Millison v. Ades of Lexington, Inc., 262 Md. 319, 277 A.2d 579 (1971); Dubiner's Bootery, Inc. v. General Outdoor Advertising Co., 10 App. Div. 2d 923, 200 N.Y.S.2d 757 (1960) (per curiam); *accord* Wehle v. Haviland, 69 N.Y. 448 (1877) (Where goods wrongfully taken). *See also* Illinois Cent. R.R. v. Crail, 281 U.S. 57 (1930) (where coal dealer sued rail carrier for shortage in coal shipment).

23. Penrose v. Arrow Constr. Co., 15 Misc. 2d 512, 182 N.Y.S.2d 642 (Sup. Ct. 1958).

commentators have stated that, generally, retailers are not allowed to recover the retail value of damaged goods.[24]

Unfortunately, the precedential value of *Kaplan* is limited because of the ambiguous nature of the trial judge's instructions. The instructions did not require the jury to use the retail value, and indeed the jury was told that they were not bound by the retail value. However, the instructions did seem earlier to define market value in terms of the retail value.[25] Given this ambiguity, it is not certain whether the supreme court approved (1) setting the retail value as the correct measure of damages, (2) leaving the method of measuring damages solely to the jury's discretion, or (3) suggesting, but not requiring, the use of the retail value as a possible measure of damages. This last appears to be the best interpretation of *Kaplan*. There are several problems with this result.

First of all, the jury arguably should have more explicit directions about the proper method of measuring damages.[26] Yet the court's opinion did not clearly distinguish between wholesale and retail values, thus leaving to the State's trial judges and juries the task of attempting to discern which measurement is to be preferred. In

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24. 1 J. BONBRIGHT, THE VALUATION OF PROPERTY 293 (1937); D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES § 5.10, at 376 (1973); C. MCCORMICK, HANDBOOK ON THE LAW OF DAMAGES § 44, at 168 (1935); 1 T. SEDGWICK, A TREATISE ON THE MEASURE OF DAMAGES § 248a, at 500-01 (9th ed. 1912); 4 J. SUTHERLAND, A TREATISE ON THE LAW OF DAMAGES § 1098, at 4178-79 (4th ed. 1916).

25. *See* text accompanying note 4 *supra*. The difference between the retail price and the salvage value was $48,349.07. The plaintiffs also claimed a loss of profits of $900.00 and cleaning and repairing costs of $658.00, totaling $49,907.07, the specifically allowed maximum amount in the judge's instructions. 286 N.C. at 81-82, 209 S.E.2d at 744-45; Record at 3, 10, 11, 90. The difference between the wholesale price and the salvage value was $21,676.00 (if the wholesale price was 60% of the retail price). 286 N.C. at 81, 88, 209 S.E.2d at 744-45, 749. The jury awarded only $21,752.00. *Id.* at 81, 209 S.E.2d at 745; Record at 93. Thus the jury may have used the wholesale prices in this case. However, the reduction in damages may be due to the facts that some toys were made of metal, Record at 32, some toys were wrapped in cellophane, *id.* at 35-36, some toys were in sealed boxes, *id.* at 36-37, defendant offered evidence that there was very little dust on the goods, *id.* at 72, identical merchandise was on sale at plaintiff's other two stores, *id.* at 38-39, and defendant offered evidence that some merchandise was returned to stock at the regular price, *id.* at 71.

26. Generally, the court has said that determination of damages is in the province of the jury. Williams v. State Highway Comm'n, 252 N.C. 514, 519, 114 S.E.2d 340, 343 (1960); Lowe v. Hall, 227 N.C. 541, 546, 42 S.E.2d 670, 674 (1947). However, some guidelines are apparently necessary since it is error for the judge to fail to instruct the jury as to the rule for measuring damages. Godwin v. Vinson, 254 N.C. 582, 586-87, 119 S.E.2d 616, 619-20 (1961); Adams v. Beaty Serv. Co., 237 N.C. 136, 142-43, 74 S.E.2d 332, 337 (1953). *But cf.* Crouse v. Vernon, 232 N.C. 24, 34-35, 59 S.E.2d 185, 192 (1950) (It is not error for the judge to instruct the jury in terms of "market value," without explaining its meaning, unless specifically requested to do so.).

the course of its opinion, the court cited only three cases, all for the proposition that the measure of damages is the difference in market value before and after the injury.[27] The court's failure to explain "which market" should have been used oversimplified the issue and left a nagging ambiguity unanswered.

To the extent that the court's holding allows measurement of damages by the retail value, it is subject to two major criticisms. First, to award retail value assumes that all of the goods could be sold at retail without additional costs. As the New York Court of Appeals noted:

> The retail value . . . supposes no damage to or depreciation in the value of the goods, and is dependent upon the contingency of finding purchasers . . . within a reasonable time, the sale of the entire stock without the loss by unsaleable remnants, and the closing out of a stock of goods as none ever was, or ever will be closed out, by sales at retail at full prices.[28]

Even if all goods could be sold at retail price, the seller would normally have such expenses as rent and labor during the time necessary to sell the goods.[29] Thus, the retail value measure of damages still awards gross rather than net profits, unless the overhead costs are subtracted.[30] It can be argued that the court, by allowing the jury to award the difference in retail value before and after the damage, dispensed with the necessity of proving profits. It is questionable whether any modern tendency to award profits[31] should be so extended. Some evidence that the goods would be actually sold should be required.[32] Moreover, it is highly unlikely that the mere existence of marked prices guarantees that all the goods will be sold at those

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27. 286 N.C. at 83, 209 S.E.2d at 746. In fact, one of the cases cited, Carolina Power & Light Co. v. Paul, 261 N.C. 710, 136 S.E.2d 103 (1964), found the general market value rule inapplicable and held that the measure of damages for damage to a power pole to be the cost of replacement.

28. Wehle v. Haviland, 69 N.Y. 448, 451 (1877); *accord*, Chicago Title & Trust Co. v. W.T. Grant Co., 2 Ill. App. 3d 483, 486, 275 N.E.2d 670, 672-73 (1971) ("No consideration is given to damage to the merchandise that might be caused by customers of the store, shoplifting, obsolescence, or a mark down on merchandise that the store might be unable to sell at the regular retail price.").

29. Millison v. Ades of Lexington, Inc., 262 Md. 319, 326-27, 277 A.2d 579, 583-84 (1971).

30. For what period of time should the overhead costs be measured when the turnover rate is unknown?

31. Reliable Trucking Co. v. Payne, 233 N.C. 637, 639, 65 S.E.2d 132, 133 (1951); D. DOBBS, *supra* note 24, § 3.3, at 154-55.

32. *See* cases cited note 13 *supra*; D. DOBBS, *supra* note 24, § 3.3, at 154; C. MCCORMICK, *supra* note 24, § 44, at 168 n.27.

prices.[33] In *Kaplan* the toy store had been operated for fifteen years,[34] ample time in which to establish the rate of inventory turnover, but no such evidence was required. In fact, no evidence specifically related to lost profits was offered,[35] although the fact that the plaintiffs had made a separate claim for lost profits[36] indicates that they themselves considered that profits should be treated separately from the value of the goods.[37]

A more fundamental flaw in using the difference in the retail value as the measure of damages is that such measurement dispenses with the doctrine of avoidable consequences. Presumably, absent contrary evidence, a seller could replace the damaged goods and make the same profit from the replacements as from the original goods.[38] If the seller promptly replaced the goods, awarding him the retail value of the damaged goods would permit him to receive a windfall double profit.[39] On the other hand, assuming a fixed number of customers, the seller's purchase of replacement goods may decrease the number of customers willing to buy the damaged goods. Moreover, if he tries to salvage the damaged goods, he may incur additional storage costs, which might well be prohibitive. Nevertheless, before the plaintiff recovers the difference in retail value, he should at least be required to show either his inability to replace the goods promptly or the unreasonableness, for the reasons just mentioned, of prompt replacement.[40]

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33. This conclusion does not seem changed because the goods were marked at fair trade prices in *Kaplan*. Record at 34. However, the argument in International Harvester Co. v. Chicago, M. & St. P. Ry., 186 Iowa 86, 119, 172 N.W. 471, 484 (1919), that the prices were fixed by the seller, and so could be any amount however unreasonable, is not present in *Kaplan*.

34. Record at 17.

35. 286 N.C. at 85, 209 S.E.2d at 747.

36. *Id.* at 81, 209 S.E.2d at 745; Record at 3.

37. Of course, the supreme court's decision does have the advantage of allowing a convenient measure of damages that the jury can use if it feels future sales likely. Future sales may have been likely in *Kaplan*, as the damage (to toys) came at the beginning of the Christmas buying season, according to the complaint. Record at 3.

38. 1 J. BONBRIGHT, *supra* note 24, at 294; *cf.* D. DOBBS, *supra* note 24, § 5.11, at 388.

39. The opportunity for a double profit is much more realistic in a case such as *Kaplan* than in a situation where a customer breaks one article in a store (and is often requested to pay the retail price).

40. Generally, in North Carolina, the plaintiff must show his inability to replace the item(s) of which he is deprived before recovering loss of profits, although it is impossible to say that this is a universal requirement. *See* Roberts v. Pilot Freight Carriers, Inc., 273 N.C. 600, 607-08, 160 S.E.2d 712, 718 (1968); Reliable Trucking Co. v. Payne, 233 N.C. 637, 638, 65 S.E.2d 132, 132 (1951); Davidson Hardware Co. v.

To measure damages by the wholesale value, as advocated by the dissent in *Kaplan*, also creates problems, but these do not appear insurmountable. First, given a fluctuating wholesale market, the accuracy of the wholesale value used as a measure of damages will be uncertain.[41] Since the wholesale value may increase before the plaintiff has an opportunity to replace damaged merchandise, the measure of damages should be the wholesale value at the time of replacement, rather than the wholesale value immediately before the damage as suggested by the dissent in *Kaplan*.[42] Secondly, if, as one well-known case held,[43] the measure of damages is the wholesale value before damage less the wholesale market value after damage, there is a problem in discovering the wholesale value of a damaged article.[44] Thus, reducing the award by the price at which the damaged articles could actually be sold to retail customers[45] seems the more workable rule. Thirdly, measurement by wholesale costs should not preclude additional recovery for transportation costs in bringing the replacement goods to the store,[46] and *extra* labor costs occasioned by the entire event.[47] Fourthly, even recovery of the wholesale cost by the merchant may overcompensate him, since he might not have sold some, or any, of the goods.[48] Finally, rejection of the retail value as a measure of damages should not necessarily exclude *evidence* of the retail value since the average markup might be subtracted therefrom to determine the wholesale value.[49] Likewise, the amount of damages might be subtracted to determine the salvage value.[50]

Delker Buggy Co., 167 N.C. 423, 426, 83 S.E. 557, 559 (1914); Johnson v. Railroad Co., 140 N.C. 574, 575, 53 S.E. 362, 362-63 (1906).

41. *See* Wehle v. Haviland, 69 N.Y. 448, 450 (1877).

42. The New York Court of Appeals has said, "The plaintiff was entitled to recover . . . the price at which [the goods] could be replaced for money in the market . . . ." *Id.*

43. Whaley v. Crutchfield, 226 Ark. 921, 927, 294 S.W.2d 775, 779 (1956).

44. *Id.* at 928, 294 S.W.2d at 780 (Ward, J., dissenting).

45. Skaggs Drug Centers, Inc. v. City of Idaho Falls, 90 Idaho 1, 10-11, 407 P.2d 695, 699-700 (1965).

46. Sears v. Lydon, 5 Idaho 358, 364, 49 P. 122, 123 (1897); Millison v. Ades of Lexington, Inc., 262 Md. 319, 327, 277 A.2d 579, 584 (1971).

47. Millison v. Ades of Lexington, Inc., 262 Md. 319, 327, 277 A.2d 579, 584 (1971). *See also* Wehle v. Haviland, 69 N.Y. 448, 451 (1877), where the court allowed interest on the wholesale value to "tak[e] the place of the uncertain and indefinite profits which the plaintiff might have made."

48. D. DOBBS, *supra* note 24, § 5.10, at 376.

49. *See* Lubin v. City of Iowa City, 257 Iowa 383, 394, 131 N.W.2d 765, 772 (1964).

50. *See* Kaplan v. City of Winston-Salem, 21 N.C. App. 168, 173, 203 S.E.2d 653, 657 (1974).

In conclusion, the decision in *Kaplan* in effect will permit juries to award the retail seller damages based upon gross profits, without proof of likely net profits, overhead expenses actually paid, or inability to replace the goods promptly. Therefore, a more equitable approach would involve awarding damages based upon wholesale cost, less salvage value, plus "demonstrably proven"[51] net profits for the period necessary to replace the goods,[52] plus overhead costs which necessarily continued after the damage,[53] plus any other necessarily incurred costs.[54] Such a measurement might result in awarding retail prices on many goods, plus some other costs, but it would place the burden of proving sales figures, demand, and replacement data on the retail seller, who is more likely to know them. For the present, however, *Kaplan* will allow juries to guess at these factors and will make it possible for a retail seller to recover an unjustified windfall profit.

DURANT M. GLOVER

Disability Insurance—Too Disabled to Come Within the Coverage of One's Policy

In *Duke v. Mutual Life Insurance Co.*[1] the Supreme Court of North Carolina construed a physician's-care clause in a disability insurance policy. Rather than looking behind the provision to its purpose, the court read the clause literally and joined a small minority of jurisdictions that would deny recovery to a claimant whose disability has stabilized to the point of requiring no further medical care.

Plaintiff Raymond L. Duke sued the Mutual Life Insurance Com-

51. *Id.* at 173, 203 S.E.2d at 656.

52. *Cf.* Cranston Print Works Co. v. Public Serv. Co., 291 F.2d 638 (4th Cir. 1961), a case from North Carolina, in which a cloth printing and dyeing plant was damaged by an explosion of gas. The court said it would not have been error to admit evidence of actual past production compared to actual production from the time of damage to the time of repair as a basis for recovering lost profits.

53. Of course, continuing overhead costs attributable to undamaged goods should not be recovered.

54. In Dubiner's Bootery, Inc. v. General Outdoor Advertising Co., 10 App. Div. 2d 923, 200 N.Y.S.2d 757 (1960) (per curiam), the court held the measure of damages to be "replacement cost and any damages actually sustained by reason of the absence of the articles while in the process of replacement." *Id.* at 923, 200 N.Y.S.2d at 758.

1. 286 N.C. 244, 210 S.E.2d 187 (1974).

pany of New York (MONY) on a disability insurance policy he procured in 1961. The policy provided for payments of 400 dollars monthly for twenty-four months if the insured became totally disabled before reaching age sixty-five and a continuation of payments provided, among other things, that " '(a) such disability requires the Insured to be under the regular care and attendance of a legally qualified physician other than himself.' "[2]

In response to questions presented to it by the trial court, the jury found that plaintiff was totally disabled and within the terms of the policy except that his disability did not require him to remain under a physician's care after April 12, 1970, the last date on which MONY had made a payment on the policy to Duke. The trial judge entered judgment for MONY and Duke appealed.[3] The North Carolina Court of Appeals unanimously reversed and required a new trial. Noting that "the courts are reluctant to require the performance of futile acts,"[4] Judge Baley declined to follow literally the clause calling for care of a physician when such care would be useless.

The North Carolina Supreme Court, however, granted certiorari and reinstated the trial judge's verdict for MONY. The opinion of Justice Higgins rested on two grounds. First, the wording of the policy was in no way ambiguous; thus, the medical-care term had to be enforced as it was written. Secondly, there was a "lack of need" since Duke no longer required "the regular care and attendance by his doctor."[5]

Clauses in disability policies requiring medical care are standard, and the purposes for their inclusion are several[6]—the prevention of fraudulent claims, the establishment of the good faith of the claimant, and the requirement that the claimant minimize his damages.[7]

2. *Id.* at 245, 210 S.E.2d at 188.

3. The trial was held in Wake County Superior Court, Judge Hobgood presiding. *Id.* at 244-45, 210 S.E.2d at 187.

4. 22 N.C. App. 392, 397, 206 S.E.2d 796, 799 (1974).

5. 286 N.C. at 247, 210 S.E.2d at 189.

6. S. HUEBNER & K. BLACK, LIFE INSURANCE 260 (7th ed. 1969). Frequently the clauses require a particular number of doctor visits per week or month. *E.g.*, 15 G. COUCH, CYCLOPEDIA OF INSURANCE LAW § 53:163 (2d ed. 1966). Whatever particular form the clause might take, "[t]he requirement of the attendance of a physician under a health and accident policy has been generally held to be a valid and enforceable provision . . . ." Knipmeyer, *Requirements of Confinement and Medical Care Under Health and Accident Policies*, 24 INS. COUNSEL J. 149, 152 (1957), *updated in* 33 INS. COUNSEL J. 405 (1966).

7. *See, e.g.*, Duke v. Mutual Life Ins. Co., 22 N.C. App. 392, 397, 206 S.E.2d 796, 799, *rev'd*, 286 N.C. 244, 210 S.E.2d 187 (1974); 15 G. COUCH, *supra* note 6, § 53:155, at 156; Knipmeyer, *supra* note 6.

The jurisdictions are not uniform in their interpretation of the clauses.[8] The minority have construed the terms literally, reasoning that an unambiguous term should be read literally,[9] that the term limits coverage,[10] and that there is no reason for recovery since there are no longer medical expenses to pay.[11] In contrast, the majority of jurisdictions base a more liberal construction on the view that the term serves merely an evidentiary purpose[12] and strict enforcement would frequently require the performance of useless acts.[13]

The first argument of the literal constructionist—the lack of ambiguity—is shortsighted. When a court considers the purpose behind the provision, the term is ambiguous about when and how it should be applied. "[T]his provision [physician's-care] is to guard against fraudulent claims and *the provision should be construed from the point of view of such a purpose.*"[14] The Idaho Supreme Court, considering the argument of no ambiguity, reasoned as follows:

> It is urged by appellant that the contract of insurance is unambiguous and that there is no room for interpretation; that being unambiguous it will be construed as any other contract. This court has so held. . . . On the other hand, this court has also committed itself to the rule with reference to insurance policies that in instances where a clause therein is susceptible to more than one construction the one most favorable to insured will be adopted, and such contracts will be construed in view of their general objects and conditions prescribed by the insurer rather than based upon a strict and technical interpretation.[15]

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8. *See, e.g.*, Annot., 84 A.L.R.2d 375 (1962). Although several states have conflicting cases so that exact figures are difficult to ascertain, the proportion of liberal to literal interpretation jurisdictions is about two to one.

9. *E.g.*, United Am. Ins. Co. v. Selby, 161 Tex. 162, 338 S.W.2d 160 (1960).

10. Mills v. Inter-Ocean Cas. Co., 127 W. Va. 400, 33 S.E.2d 90 (1945).

11. Duke v. Mutual Life Ins. Co., 286 N.C. 244, 210 S.E.2d 187 (1974).

12. *E.g.*, Penrose v. Commercial Travelers Ins. Co., 75 Idaho 524, 275 P.2d 969 (1954).

13. *E.g.*, Brown v. Continental Cas. Co., 209 Kan. 632, 498 P.2d 26 (1972); Music v. United Ins. Co., 59 Wash. 2d 765, 370 P.2d 603 (1962). *Duke* did not require the doing of a useless act. The clause provided that the " 'disability require . . . regular care and attendance of a . . . physician . . . .' " 286 N.C. at 245, 210 S.E.2d at 188. Thus the clause completely foreclosed recovery by Duke. However, some policies are worded such that, if a court followed the decision in *Duke*, there would be a requirement of useless doctor visits in order to recover under the policy. *See, e.g.*, Penrose v. Commercial Travelers Ins. Co., 75 Idaho 524, 275 P.2d 969 (1954), in which the clause read as follows: " 'Provided that benefits . . . shall not be paid in excess of the time the Insured is under the regular attendance of a . . . physician or surgeon . . . .' " *Id.* at 528, 275 P.2d at 971.

14. Knipmeyer, *supra* note 6, at 152 (emphasis added and footnote omitted).

15. Penrose v. Commercial Travelers Ins. Co., 75 Idaho 524, 532, 275 P.2d 969, 973 (1954).

The North Carolina Supreme Court has recognized the rule followed by Idaho of construing insurance policies against the insurer,[10] but in *Duke* the court's failure to look at the purpose precluded recognition of the ambiguity in the clause. In *Evans v. Transportation Insurance Co.*[17] the court did recognize an ambiguity in an analogous situation. *Evans* involved a confinement clause of a disability policy. Rather than remaining in his home all the time as a literal reading of the clause required, the claimant went to the post office, drove to a barber, and was in other ways able to make limited trips out of his house. The supreme court, in an opinion by Justice Sharp, adopted a liberal reading of the clause and allowed recovery. The court held that the clause should be treated "as descriptive of the extent of the illness or injury rather than as a limitation upon insured's conduct."[18]

The second argument for a literal reading of the physician's-care clause, that it limits coverage and therefore should be construed strictly, begs the question of interpretation. By making the conclusory statement that the clause limits coverage, the courts completely ignore any inquiry into the purpose of the clause.[19]

Duke offered the third justification for a literal reading of a physician's-care clause. Once medical expenses are no longer necessary, there is a "lack of need" for recovery on the policy.[20] The court reasoned that "[t]he purpose of the coverage was to reimburse the in-

16. *E.g.*, Duke v. Mutual Life Ins. Co., 286 N.C. 244, 247, 210 S.E.2d 187, 189 (1974); Note, *The Insurance Contract and Policy in General as it Relates to North Carolina*, 3 N.C. CENT. L.J. 259, 265-66 (1972).

17. 269 N.C. 271, 152 S.E.2d 82 (1967).

18. *Id.* at 274, 152 S.E.2d at 84. *But see* Walsh v. United Ins. Co., 265 N.C. 634, 144 S.E.2d 817 (1965), in which recovery was denied because the policy itself contained an explicit definition of "confinement." The liberal interpretation of confinement clauses is the overwhelming majority view. *See, e.g.*, J. APPLEMAN & J. APPLEMAN, 1A INSURANCE LAW AND PRACTICE § 652 (1965); 15 G. COUCH, *supra* note 6, §§ 53:141-42.

19. In this respect this argument suffers from the same faults as the argument that the clause is not ambiguous. *See* text accompanying notes 14-18 *supra*. The justification given by the minority jurisdictions for these two arguments is that since the two parties have reached an agreement and their intent is embodied in the terms of that agreement, there is no need to look behind the language of the contract. *See, e.g.*, Duke v. Mutual Life Ins. Co., 286 N.C. 244, 247, 210 S.E.2d 187, 189 (1974). This justification ignores the unequal bargaining positions of the parties to an insurance policy. *See, e.g.*, Barker v. Iowa Mut. Ins. Co., 241 N.C. 397, 85 S.E.2d 305 (1955), discussing the unlikelihood of an applicant having anything to do with drawing up a fire insurance policy.

20. 286 N.C. at 247, 210 S.E.2d at 189. *Duke* apparently is the only case to have made this argument.

sured to the extent of the medical expenses incurred in the course of the regular care and attendance by his doctor."[21] The propriety of this statement is particularly difficult to understand since the claimant was suing to collect on a disability policy, not a health or medical expenses policy. While the purpose of the latter is to cover the medical expenses, a disability policy has as its purpose income protection, *i.e.* a person takes out a disability policy so that if he ever becomes disabled, he will not lose all sources of income.[22] Thus, to deny Duke recovery on his disability policy claim, not because of a lack of a disability but because of a lack of medical expenses, seems to be judicial interference into the very purpose of disability insurance.

The reasoning of the majority of jurisdictions is sounder. Compliance with the clause serves merely as evidence of disability.[23] Since the basic purposes of the clause relate to prevention of fraudulent or bad faith claims,[24] once an actual disability is proved and good faith by the claimant is established, the clause has no function.[25] If a refusal to minimize damages is alleged by the insurance company, the clause may again be used, but only as evidence of the claimant's bad faith and not necessarily as an absolute bar.[26]

The argument of the majority is strongest in fact situations like that presented in *Duke*.[27] When the claimant has a disability that

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21. *Id.*

22. *See generally* Glenn v. Gate City Life Ins. Co., 220 N.C. 672, 18 S.E.2d 113 (1942).

23. *See* text accompanying note 12 *supra.*

24. *See* text accompanying note 7 *supra.*

25. *See* Knipmeyer, *supra* note 6.

26. *Cf.* Duke v. Mutual Life Ins. Co., 22 N.C. App. 392, 206 S.E.2d 796, *rev'd*, 286 N.C. 244, 210 S.E.2d 187 (1974).

27. Most courts that have adopted the literal interpretation rule have done so in cases in which the dispute was over matters such as the definition of a physician or a definite schedule of visits. *E.g.*, Bruzas v. Peerless Cas. Co., 111 Me. 308, 89 A. 199 (1913) (court required literal compliance with a clause requiring a physician's visit at least once every seven days); United Am. Ins. Co. v. Selby, 161 Tex. 162, 338 S.W.2d 160 (1960) (court strictly construed the clause not to include a naturopath); Isaacson v. Wisconsin Cas. Ass'n, 187 Wis. 25, 203 N.W. 918 (1925) (court's literal interpretation excluded a chiropractor from the clause). But in a fact situation similar to *Duke*, the case seems so overwhelming to allow recovery that one writer claimed "courts invariably hold that such requirement will not be permitted to defeat recovery when the evidence shows that regular medical care will not improve the insured's condition." Siebert, *The Insured Event: Disability Insurance*, 1964 U. ILL. L.F. 382, 400 (footnote omitted). Language from several cases makes this statement of doubtful validity even in 1964. Mutual Benefit Health & Accident Ass'n v. Cohen, 194 F.2d 232 (8th Cir.), *cert. denied*, 343 U.S. 965 (1952); Lustenberger v. Boston Cas. Co., 300 Mass. 130, 14 N.E.2d 148 (1938). *But see* Shaw v. Commercial Ins. Co., 359 Mass. 601, 270 N.E.2d 817 (1971) (seriously questioning *Lustenberger*'s continuing validity in Massachusetts).

doctors say is stable and cannot be helped by further medical care, the purposes of the clause are satisfied. The doctors' statements that medical care cannot improve the claimant's condition verify that neither a fraudulent claim nor bad faith is involved. A literal reading of the clause would in many cases advocate waste of the physician's and claimant's time and the claimant's money[28] by requiring useless visits in order to continue eligibility under the policy.[29] Furthermore, minimization of damages would not be an issue because of the stability of the claimant's condition.

Due to a failure to consider the purpose of the clause, the North Carolina Supreme Court followed the minority of jurisdictions in giving a literal reading to the physician's-care clause in *Duke*. In so doing, the court defeated an important purpose of disability policies.[30] Contrary to the expectations of the insured,[31] *Duke* held that one who is so disabled that medical care can no longer help him is beyond the limits of his policy's coverage.

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28. One might argue that if the claimant recovers on the policy he is not wasting his money because he can use the proceeds of the policy to pay for the useless doctor visits. However, the proceeds of a disability policy are not intended to cover medical bills but are a substitute income. Thus to spend those proceeds on useless doctor visits would be the same as spending one's income in that manner. *See* text accompanying notes 20-22 *supra*.

29. *See* note 14 *supra*. The Kansas Supreme Court once answered the question of whether a physician's-care clause required useless doctor visits with another question: "Suppose a policyholder is totally and permanently disabled through the loss of sight in both eyes—would any court require the weekly attention of a physician in order to secure continuing benefits provided by the policy?" Hodgson v. Mutual Benefit Health & Accident Ass'n, 153 Kan. 511, 518, 112 P.2d 121, 126 (1941).

30. *See, e.g.*, Massachusetts Bonding & Ins. Co. v. Springston, 283 P.2d 819 (Okla. 1955); text accompanying note 22 *supra*.

31. *See* R. KEETON, BASIC TEXT ON INSURANCE LAW § 6.3 (1971). Professor Keeton argues that since insurance policies are contracts of adhesion, the following principle should be followed: "The objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations." *Id.* at 351. Keeton says "this principle points in the direction insurance law appears to be moving." *Id.*

Domestic Relations—The Ineffective Use of Blood-Grouping Tests in North Carolina

In *State v. Camp*[1] the North Carolina Supreme Court upheld defendant's conviction for refusing to support an illegitimate child who could not possibly have been the defendant's offspring. The court reached its conclusion by holding that the results of blood-grouping tests, which showed that the defendant could not have fathered the child, were entitled to no more weight than other evidence offered on the issue of paternity. By refusing to follow the court of appeals in taking judicial notice of a widely accepted scientific principle, the court displayed a narrow perception of the advances in blood-grouping technology made during the past twenty-five years.

In *Camp* the State charged defendant with willful neglect and refusal to support his minor illegitimate child.[2] The State's case rested entirely on the testimony of the complaining witness, the mother, Mary Hames. She testified that she was unmarried and the mother of Timothy Hames who was born on July 12, 1973, a full-term baby. She further testified that in October 1972 she became pregnant and that she had sexual intercourse with the defendant a number of times in October and November and with no one else. Before the trial, defendant moved for a blood-grouping test pursuant to North Carolina General Statutes section 8-50.1[3] to determine whether or not he could possibly be the biological father of the child. Consequently, blood tests involving defendant, mother and child were conducted on three separate days, and revealed that both the mother and the defendant were

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1. 286 N.C. 148, 209 S.E.2d 754 (1974).

2. N.C. GEN. STAT. § 49-2 (1966). This section specifies that one who willfully neglects or who refuses to support and maintain his or her illegitimate child shall be guilty of a misdemeanor.

3. *Id.* § 8-50.1 (1969), provides:

> **Competency of evidence of blood tests**—In the trial of any criminal action or proceedings in any court in which the question of paternity arises, regardless of any presumptions with respect to paternity, the court before whom the matter may be brought, upon motion of the defendant, shall direct and order that the defendant, the mother and the child shall submit to a blood grouping test . . . . The results of such blood grouping tests shall be admitted in evidence when offered by a duly licensed practicing physician or other qualified person. Such evidence shall be competent to rebut any presumptions of paternity.
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> In the trial of any civil action, the court before whom the matter may be brought, upon motion of either party, shall direct and order that the defendant, the plaintiff, the mother and the child shall submit to a blood grouping test . . . . The results of such blood grouping tests shall be admitted in evidence when offered by a duly licensed practicing physician or other duly qualified person.

of blood-group O, while the child was of blood-group A. The medical expert who performed the tests testified that from his study of medicine he had an opinion that defendant could not be the father of the child because a male and female with group O blood cannot produce an infant with group A blood. The trial judge charged the jury that according to North Carolina law blood-grouping tests are not conclusive on the issue of paternity, and that they should consider the test results with all the other evidence in reaching a decision. The jury found the defendant guilty of refusing to support his illegitimate child.[4] The court of appeals found error in the instruction given by the trial judge and ordered a new trial.[5] The court ordered the trial judge, in formulating his instructions, to take judicial notice that a man and woman of blood-group O cannot have a child of group A. After recognizing the laws of heredity, the court of appeals would then require the trial judge to instruct the jury that, if they believed the testimony of the Doctor and that the tests were properly administered, it would be their duty to return a verdict of not guilty. The supreme court reversed,[6] holding that the legislature had not given the test results conclusive weight and thus, they should be considered on a par with all other testimony.

The A-B-O blood-grouping test was discovered in 1901 by Landsteiner.[7] By examining an individual's red blood cells, the test is used to determine whether either or both of two substances known as agglutinogen A and agglutinogen B are present. An individual's blood-group is identified by the presence or absence of these two substances. If both substances are present, the individual's blood is classified as

4. According to the facts as recited by the North Carolina Court of Appeals, defendant "was sentenced to six months' imprisonment, suspended on condition that he pay $15.00 per week for the support of the child, plus $620.00 for expenses already incurred." State v. Camp, 22 N.C. App. 109, 110, 205 S.E.2d 800, 801 (1974). Since N.C. GEN. STAT. § 49-2 (1966) defines "child" as one under the age of eighteen, the defendant's total liability is equal to approximately $14,660.

5. 22 N.C. App. 109, 205 S.E.2d 800 (1974).

6. 286 N.C. 148, 209 S.E.2d 754 (1974) (two judges dissented).

7. Comment, *The Use of Blood Grouping Tests in Disputed Parentage Proceedings—A Scientific Basis for Discussion*, 50 MICH. L. REV. 582, 583 (1952). There are more complex tests now available for testing for blood groups, however the basic A-B-O test is reliable for proof of nonpaternity in this case. For a more complete discussion of blood-grouping tests see S. SCHATKIN, DISPUTED PATERNITY PROCEEDINGS (3d ed. 1953); Ross, *The Value of Blood Tests as Evidence in Paternity Cases*, 71 HARV. L. REV. 466 (1958); Whitlatch & Marsters, *Contributions of Blood Tests in 734 Disputed Paternity Cases: Acceptance by the Law of Blood Tests as Scientific Evidence*, 14 W. RES. L. REV. 115 (1962); Comment, *California's Conclusive Presumption of Legitimacy*, 35 S. CAL. L. REV. 437 (1962); *California's Tangled Web: Blood Tests and the Conclusive Presumption of Legitimacy*, 20 STAN. L. REV. 754 (1968); Annot., 46 A.L.R.2d 1000 (1956); Annot., 163 A.L.R. 939 (1946).

group AB; if neither is present, the blood is classified as group O. If only agglutinogen A is present or if only agglutinogen B is present the blood is classified as group A or B respectively.[8]

Blood-group testing has proved to be a valuable tool in determining the identity of a child's parents. In this respect medical experts agree that an individual's blood-group can be determined at birth, that it remains the same throughout his lifetime, unaffected by age, disease, or medication, and more importantly, that a child inherits his blood group from his parents.[9] Furthermore, as explained by Mendel's laws of genetics, an individual cannot possess a blood-group factor which is absent in both of his true parents. Therefore, when the blood types of the mother and child are known, medical experts can determine scientifically what the blood type of the father may be and what it cannot be.[10]

In addition to their scientific reliability as proof of non-paternity, the use of blood-grouping tests in paternity suits is especially valuable since contradictory testimony is unusually self-serving.[11] As an Ohio court in *State ex rel. Steiger v. Gray* observed:

> The alleged intercourse between the woman and the putative father is almost always carried on clandestinely and secretly. Seldom if ever is there any reliable corroborating eyewitness testimony. Circumstantial evidence must be relied upon to a great extent. In other words, such testimony in such cases may be as reliable or as unreliable as the persons giving it.[12]

The dubious value of the mother's testimony in paternity suits has been confirmed by two studies demonstrating that when the defendant's non-

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8. Note, *Blood-Grouping Tests and the Presumption of Legitimacy*, 50 N.C.L. REV. 163, 165 (1971). *See also* C. MCCORMICK, HANDBOOK OF THE LAW OF EVIDENCE § 211 (2d ed. E. Cleary 1972); 1 J. WIGMORE, EVIDENCE § 165b (3d ed. 1940).

9. Note, 50 N.C.L. REV., *supra* note 8, at 165.

10. Comment, *Blood Grouping Test Results: Evidential Fact or Conclusions of Law?*, 23 WASH. & LEE L. REV. 411, 416 (1966) (Medical experts agree that the test results are conclusive only in excluding the putative father). The medical profession apparently admits that, theoretically due to possible mutation of the genes, two parents with type O blood might produce a child with type A blood in one out of 50,000 to 100,000 cases. Comment, *Conclusiveness of Blood Tests in Paternity Suits*, 22 MD. L. REV. 333 (1962).

11. See, State *ex rel.* Steiger v. Gray, 3 Ohio Op. 2d 394, 76 Ohio L. Abs. 393, 145 N.E.2d 162, 165 (Juv. Ct. Cuyahoga County 1957). The fact that the medical expert testifying in the case is a disinterested third person should make his testimony more credible than that of the parties. Comment, 23 WASH. & LEE L. REV., *supra* note 10, at 420-21.

12. 3 Ohio Op. 2d 394, 397, 76 Ohio L. Abs. 393, 397, 145 N.E.2d 162, 165 (Juv. Ct. Cuyahoga County 1957). *See also* Jordon v. Mace, 144 Me. 351, 355, 69 A.2d 670, 672 (1949).

paternity is established by blood-grouping tests, the mother usually admits that the man charged was not the only one who could have been the father.[13]

Despite the evidentiary value of blood-grouping tests, until recently courts have been reluctant to admit them as evidence and, once admitted, to give them conclusive weight. Assumption of risk by a putative father[14] and the State's concern that the child will be its charge[15] are sometimes given or assumed as possible explanations for courts' refusals to hear or give conclusive weight to the test evidence.[16] However, when the issue of paternity does not involve the risk of bastardization, these reasons are not substantial.[17]

In the last twenty years state legislatures have increasingly responded to the courts' lethargy with statutes according conclusive

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13. S. SCHATKIN, *supra* note 7; Whitlatch & Marsters, *supra* note 7.

14. C. MCCORMICK, *supra* note 8, § 211, at 521-22 (possible explanation for a jury's disregarding blood-grouping tests when the court does not instruct the jury to give test results conclusive weight).

15. Britt, *Blood Grouping Tests and the Law: The Problem of "Cultural Lag"*, 21 MINN. L. REV. 671, 681 (1937), where Britt comments on the court's decision in Commonwealth v. Morris, 22 Pa. D. & C. 111, 113 (Q.S. Luzerne County 1934): "Since the court gave the shop-worn argument that proper authority must come from the legislature, it apparently preferred to let the defendant bear the burden of supporting the child, regardless of the fact that he might be innocent, rather than to transfer liability for the child's support to the poor district or some charitable agency." In his article, Britt offers several reasons for the courts' reluctance to hear and give conclusive weight to blood-grouping tests, which he labels the courts' "cultural lag." Britt, *supra* at 696-702.

16. Although the North Carolina Supreme Court did not articulate any policy basis for its decision not to give conclusive weight to blood-grouping tests in *Camp*, North Carolina courts and the North Carolina legislature have attempted to place support responsibilities for illegitimate children on the natural parents when they are known. The present statute, N.C. GEN. STAT. § 49-2 (1966), is a criminal statute designed to require support of an illegitimate child by the natural father. Its predecessors are ch. 15 § 1, [1851] N.C. Sess. Laws 44, N.C. Code ch. 5 § 32 (1883), and N.C. Rev. Stat. ch. 12 §§ 1, 4 (1837). Chapter 15, section 1 of the 1851 North Carolina Sessions Laws provided that testimony by the mother of the illegitimate child shall be presumptive evidence against the person accused of being the father. Prior to this statute the law of North Carolina as later reflected in the N.C. Code of 1883 provided that when a single woman "big with child" was brought to the attention of a justice of the peace in the county in which the woman resides, she would be brought to him to be examined upon oath respecting the father; if she refused to name the father, "she shall pay a fine of five dollars, and give a bond payable to the state, with sufficient surety, to keep such child or children from being chargeable to the county, otherwise she shall be committed to prison until she shall declare the same [the father], or pay the fine aforesaid and give such bond. . . ." N.C. Code ch. 5 § 32 (1883). This law is almost verbatim N.C. Rev. Stat. ch. 12 §§ 1, 4 (1837). For a discussion of ch. 15 § 1, [1851] N.C. Sess. Laws 44 see 2 STANSBURY'S NORTH CAROLINA EVIDENCE § 247 (Brandis rev. 1973) [hereinafter cited as STANSBURY] and cases cited therein.

17. Comment, 23 WASH. & LEE L. REV., *supra* note 10, at 412.

weight to the test results.[18] In jurisdictions in which there is no statute regarding blood-grouping test results or a statute that does not define the weight to be given such tests, many courts have taken judicial notice of the immutable laws of genetics and have instructed juries that properly administered tests establishing nonpaternity are conclusive on that issue.[19] In several jurisdictions in which test results are admitted into evidence by a statute that is silent with respect to their evidentiary weight, courts purport to be following the purpose and intent of the legislature by taking judicial notice of the conclusive nature of the tests.[20] These courts reason that the legislature intended the "light of science to be brought to bear"[21] on a case in which nonpaternity is established by the statutorily approved tests. Permitting juries to disregard this scientific proof countermands the legislature's intent. Only a few jurisdictions still refuse to recognize the "universal negative truth"[22] of heredity by excluding blood-grouping test results or by allowing juries to disregard test results which establish nonpaternity.[23]

North Carolina, as revealed in *Camp*,[24] regrettably remains in that small minority of states in which nonpaternity established by blood-grouping tests is not given conclusive evidentiary weight. The supreme court places the blame for this apparent miscarriage of justice on the legislature's failure to specify the weight to be given the test results. But the court should not be allowed to absolve itself so easily.

In its decision the court relied partly on two California cases. In *Arais v. Kalensnikoff*[25] a seventy-year-old impotent defendant was found to be the father of the complainant's child despite blood-grouping tests that established nonpaternity. A similar result was reached

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18. Several states have adopted in whole or in part the UNIFORM ACT ON PATERNITY which gives conclusive weight to blood-grouping tests which establish nonpaternity. *Id.* § 10. Kentucky, Maine, Mississippi, Montana, New Hampshire, and Utah are states which have adopted the Act.

19. *See, e.g.*, Jordon v. Mace, 144 Me. 351, 69 A.2d 670 (1949); Shanks v. State, 185 Md. 437, 45 A.2d 85 (1945); Groulx v. Groulx, 98 N.H. 481, 103 A.2d 188 (1954); Cortese v. Cortese, 10 N.J. Super. 152, 76 A.2d 717 (App. Div. 1950); Clark v. Rysedorph, 281 App. Div. 121, 118 N.Y.S.2d 103 (1952); Houston v. Houston, 199 Misc. 469, 99 N.Y.S.2d 199 (1950). *See also* cases cited in Annot., 46 A.L.R.2d 1028 (1956).

20. Jordon v. Mace, 144 Me. 351, 69 A.2d 670 (1949); State *ex rel.* Steiger v. Gray, 3 Ohio Op. 2d 394, 76 Ohio L. Abs. 393, 145 N.E.2d 162 (Juv. Ct. Cuyahoga County 1957).

21. Jordon v. Mace, 144 Me. 351, 69 A.2d 670 (1949).

22. 1 J. WIGMORE, *supra* note 8, § 165b.

23. Ross v. Marx, 24 N.J. Super. 25, 93 A.2d 597 (App. Div. 1952). For other jurisdictions see Annot., 46 A.L.R.2d 1000 (1956).

24. 286 N.C. 148, 209 S.E.2d 754 (1974).

25. 10 Cal. 2d 428, 74 P.2d 1043 (1937).

in *Berry v. Chaplin*[26] in which the court refused to take judicial notice of the reliability of blood-grouping tests because "the conclusions reached by the examiner are based upon medical research, and involve questions of chemistry and biology with which a layman is entirely unfamiliar."[27] In both of these cases, the Supreme Court of California characterized the test results as "expert testimony," but stated that they were not entitled to conclusive weight unless "so declared by this code."[28] Thus, in 1937 the California courts were unwilling to give conclusive weight to blood-grouping tests or to judicially recognize any medical evidence with which the layman was unfamiliar, regardless of its acceptance by the scientific community. Even though these cases were decided over thirty years ago when there was perhaps more concern regarding the reliability of blood-grouping tests, the legal community was outraged. As one commentator, referring to the supreme court's opinion in *Arais*, stated:

> It remained, however, for the Supreme Court, highest judicial tribunal in the State, to render a decision that has evoked the most bitter and critical comment. It has been called "a striking miscarriage of justice." The facts in that case have been described as "standing in a niche all of their own in the judicial hall of fame."[29]

Shortly after these cases were decided the California legislature adopted the Uniform Act on Paternity that gave conclusive weight to blood-grouping tests that establish nonpaternity.[30] Thus, the cases cited by the North Carolina Supreme Court have been overruled by legislative fiat and no longer have controlling effect in California. Because of subsequent technological advances, they should not be persuasive in other states.

The supreme court's opinion in *Camp*[31] makes no mention of the court of appeals' eloquent argument in favor of taking judicial notice of scientific laws as well recognized and established as the laws of genetics. The court of appeals in *Camp*[32] was ready to judicially recognize as scientific fact the laws of genetics as they relate to blood-group-

26. 74 Cal. App. 2d 652, 169 P.2d 442 (1946).
27. *Id.* at —, 169 P.2d at 451.
28. 10 Cal. 2d 428, 432, 74 P.2d 1043, 1046 (1937).
29. S. SCHATKIN, *supra* note 7, at 250.
30. CAL. EVID. CODE § 895 (West 1966) (originally enacted in 1953).
31. 286 N.C. at 153, 209 S.E.2d at 757. The court simply characterizes the court of appeals decision as favoring a conclusive finding when blood-grouping tests establish nonpaternity.
32. 22 N.C. App. 109, 205 S.E.2d 800 (1974).

ing tests in establishing nonpaternity. The lower court apparently believed such scientific proof worthy of judicial notice as it was not merely "an expression of opinion but the statement of facts generally known"[33] —the test for judicial notice as stated by the North Carolina Supreme Court. As recognized by the court of appeals, judicial notice is not new to North Carolina courts. In fact, it has often been utilized when a fact is within the common knowledge of those within the jurisdiction or when a scientific fact is generally accepted by the scientific community.[34] Although our court system requires objectivity in an effort to ascertain the truth, "justice does not require that courts profess to be more ignorant than the rest of mankind."[35] As Professor Strong pointed out, judges should inform themselves of scientific facts by "reference to standard works on the subject."[36] Likewise, Professor Stansbury stated: " 'If in this day of rapidly advancing scientific progress the courts are to keep pace with science, they must take judicial notice of that which is generally accepted as true by those learned in the scientific fields in question.' "[37] In an effort to keep pace with science North Carolina courts have taken judicial notice of the normal term of pregnancy,[38] the principle of electrical conduction,[39] the normal causes of phlebitis[40] as well as other scientific facts.[41] Unfortunately, instead of keeping pace with advances in the field of blood-grouping tests, the court has merely passed the baton to the legislature.

In *Camp* the blood-groups of defendant and the mother were type O whereas the child was type A. The laws of genetics undisputably showed that the child's natural father could not have been of type O, thus excluding the defendant. The legislature in passing the blood-grouping statute[42] undoubtedly intended that scientific methods as

33. Starr v. Telephone Co., 156 N.C. 435, 438, 72 S.E. 484, 485 (1911). See also Comment, 23 WASH. & LEE L. REV., *supra* note 10. "[T]he pathologist whose report excludes paternity is not giving 'opinion' evidence, . . . but is testifying to a fact of life and nature." *Id.* at 420, citing R. GRADWOHL, LEGAL MEDICINE 576 (1954).

34. 1 STANSBURY § 11; 3 J. STRONG, N.C. INDEX *Evidence* §§ 1-3 (1967). *See also* 9 J. WIGMORE, *supra* note 8, § 2580.

35. State v. Vick, 213 N.C. 235, 238, 195 S.E. 779, 781 (1938).

36. 3 J. STRONG, *supra* note 34, § 3; *see also* Kennedy v. Parrott, 243 N.C. 355, 90 S.E.2d 754 (1956).

37. 1 STANSBURY § 86, at 277, *quoting* Baer, *Radar Goes to Court*, 33 N.C.L. REV. 355, 359 (1955).

38. State v. Key, 248 N.C. 246, 247-48, 102 S.E.2d 844, 845-46 (1958).

39. Starr v. Telephone Co., 156 N.C. 435, 72 S.E. 484 (1911).

40. Kennedy v. Parrott, 243 N.C. 355, 90 S.E.2d 754 (1956).

41. For a more complete discussion of the use of judicial notice in North Carolina see 1 STANSBURY §§ 11-14 and cases cited.

42. N.C. GEN. STAT. § 8-50.1 (1969).

were known and accepted in 1949 apply in such cases. But the supreme court should not have closed its eyes to the advances in science since the adoption of the blood-grouping statute, nor should it have disregarded the near unanimity of medical and legal authorities regarding the reliability of blood-grouping tests.[43] To disregard such scientific proof was to participate in a miscarriage of justice. As aptly stated by one justice who questioned the result reached in the *Chaplin* case in 1937:

> Ascertainment of the factual truth in the adjudication of any controversy is a consummation devoutly to be wished. Time was when the courts could rely only upon human testimony. But modern science brought new aids. The microscope, electricity, X-ray, psychology, psychiatry, chemistry and many other scientific means and instrumentalities have revised the judicial guessing game of the past into an institution approaching accuracy in portraying the truth as to the actual fact where, in the pursuit of which, scientific devices may be applied. . . . If the courts do not utilize these unimpeachable methods for acquiring accurate knowledge of pertinent facts they will neglect the employment of available, potent agencies which serve to avoid miscarriages of justice.[44]

CHARLOTTE A. CUNNINGHAM

Environmental Law—Municipal Immunity—Springer v. Joseph Schlitz Brewing Company: Placing the Burden on Industry

In recent years, increasing demands have been made on the judicial system to resolve the often conflicting claims between environmentalists and industry. The Fourth Circuit Court of Appeals recently faced such a problem in *Springer v. Joseph Schlitz Brewing Co.*[1] which involved the liability of an industry to downstream riparian owners when sewage from its plant overloaded the municipal sewage treatment facility. The district court held in Schlitz's favor on the basis of North

43. In response to the court's decision in *Camp*, on March 14, 1975 a bill was introduced into the House of Representatives that would give conclusive weight to blood-grouping tests that established nonpaternity. As of April 1, 1975, the bill has not been reported out of committee. House Bill 443, 1975 N.C. General Assembly.

44. 74 Cal. App. 2d 652, —, 169 P.2d 442, 453 (1946).

1. No. 73-2360 (4th Cir., Jan. 14, 1975).

Carolina's grant of immunity to a sewage system user whose waste is not adequately treated by the city. However, the court of appeals recognized two exceptions to the State's general rule of immunity[2] and used them as the basis for its reversal of the lower court.

Plaintiffs, David and Diana Springer, owned an interest in a large farm on the Yadkin River, downstream from the Schlitz brewery and the Winston-Salem sewage plant. After inadequately treated waste from the overloaded sewage facility caused six unprecedented fish kills and polluted the river in mid-1970, plaintiffs brought a diversity action against Schlitz[3] seeking an injunction and damages. They alleged that the waste from the Schlitz brewery had overloaded the sewage plant thereby causing the pollution of the Yadkin and the infringement of plaintiffs' riparian rights. The Springers contended that North Carolina's general rule of immunity for sewage system users could not shelter Schlitz if the court found that the brewery had "violated the city sewage ordinance, or if Schlitz knew, or should have known of the inability of the city to adequately treat the brewery's wastes."[4] In response, Schlitz denied liability, claiming protection under the State rule of immunity for users of municipal sewage facilities.

The court of appeals did not deny the existence of a general rule

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2. *See* text accompanying note 14 *infra.*

3. Since an action against the municipality is standard in cases such as this one and since the courts readily find liability, the question arises as to why the Springers did not sue Winston-Salem instead of Schlitz. According to Norman B. Smith, counsel for the plaintiff, the Springers and their attorneys were anxious to get at the real offending cause of the pollution rather than adding to the burden of the taxpayer. The suit was apparently more in the nature of a private attorney-general action than a suit for damages.

4. No. 73-2360 at 4. *See* WINSTON-SALEM, N.C., CODE OF ORDINANCES § 23 (1970). Winston-Salem had passed a sewage ordinance to deal with problems such as this in February 1970 to become effective in May of that year. The ordinance set up a permit system, established a limit on the BOD content (a measure of the polluting strength of wastes) of wastes discharged into the system, and prohibited the discharge of certain dangerous or hard-to-treat materials. The relevant portion of section 23-2(2) states:

> (2) Except as hereinafter provided, it shall be unlawful for any person to discharge or cause to be discharged any of the following described materials, waters, liquids, or wastes into any public sanitary sewer:
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> . . . .
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> (g) Liquid wastes containing any toxic or poisonous substances in sufficient quantities to (i) interfere with the biological processes used in a sewage treatment plant, or (ii) which, in combination with other liquid wastes, upon passing through a sewage treatment plant will be harmful to persons, livestock, or aquatic life utilizing the receiving streams into which water from a sewage treatment plant is discharged.

No. 73-2360 at 9, *quoting* WINSTON-SALEM, N.C., CODE OF ORDINANCES § 23-2(2) (1970).

of immunity for sewage system users in North Carolina and agreed that "an industry that uses a municipal sewage system to dispose of its waste is not liable to a riparian landowner for the pollution caused by the city's failure to provide adequate treatment."[5] However, the court also recognized the possibility of exceptions to this rule. After noting that the North Carolina courts had not yet ruled on these exceptions, the court turned to the "rationale for the established rule, developments on this point in other states, and analogous areas of the state's common law"[6] and found support for both exceptions alleged by plaintiffs. Consequently, the court ruled that violation of a municipal sewage ordinance enacted to protect downstream riparian owners can be the basis for finding an industrial sewage source liable.[7] Regarding plaintiffs' second alleged exception, the court analogized the relationship between a municipal sewage treatment plant and its users to that between an independent contractor and his employer.[8] Just as an employer must exercise reasonable care in selecting a contractor qualified to do the work, so must a corporation exercise reasonable care in selecting a sewer system capable of handling its waste.[9] Thus, if Schlitz were found to be negligent in selecting Winston-Salem to treat its sewage, it would be liable on this theory also.[10]

In general, North Carolina recognizes a cause of action in a riparian landowner whose riparian rights have been violated, and has adopted the rule of reasonable use[11] which states that: " '[a] riparian proprietor is entitled to the natural flow of a stream running through or along his land in its accustomed channel, undiminished in quantity and unimpaired in quality except as may be occasioned by the reasonable use of the water by other like proprietors.' "[12] However, two

5. No. 73-2360 at 3.

6. *Id.* at 4. The court examined these factors to determine North Carolina law in the absence of specific rulings on the issue.

7. *Id.* at 7.

8. *Id.* at 14-15.

9. According to the court, the corporation is in the best position to know the characteristics of its sewage and to exercise control over plant location and the sewage system to dispose of its waste. "Schlitz knew, or in the exercise of reasonable care should have ascertained, that the city could not adequately treat its brewery wastes." *Id.* at 18.

10. *Id.* at 18-19.

11. Aycock, *Introduction to Water Use Law in North Carolina*, 46 N.C.L. REV. 1, 6 (1967).

12. *Id., quoting* Smith v. Town of Morganton, 187 N.C. 801, 802-03, 123 S.E. 88, 89 (1924). Citing Professor Aycock's article on North Carolina water use law, the court ruled that "interference with riparian rights is an actionable tort." No. 73-2360 at 3. While the court uses the Aycock article to establish this point, they do not mention that Aycock discusses the general rule of immunity without noting any exceptions.

North Carolina cases clearly establish a general rule of immunity for municipal sewage systems users. In *Hampton v. Spindale*,[13] manufacturing plants owned by defendants discharged waste into the municipal sewage system. A downstream riparian owner sued the town, a manufacturer, and a power company to recover damages for the pollution of the stream. The court held:

> [T]he inhabitants of a city who invoke its power to construct and control a sewer and who use the sewer after its completion for the purpose and *in the way prescribed by law* are not liable jointly with the city for damages which result to third persons from the negligence of the city in the construction, management, or operation of the sewer.[14]

In *Clinard v. Town of Kernersville*[15] the court again held that plaintiff could maintain an action against the town, but not against a manufacturer.

The scope of the immunity established by these cases, however, is not unlimited. For example, *Hampton* limited immunity "to those persons who use the sewers 'in the way prescribed by law.' "[16] Consistent with this exception the court of appeals reasoned that, while an industry can normally expect adequate treatment of sewage, "it is not reasonable for an industry to expect a city to safely treat prohibited sewage."[17] Thus, if Schlitz violated the Winston-Salem sewage ordinance, thereby using the sewers unlawfully,[18] it could be held liable

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13. 210 N.C. 546, 187 S.E. 775 (1936).
14. *Id.* at 548, 187 S.E. at 776 (emphasis added).
15. 215 N.C. 745, 3 S.E.2d 267 (1939).
16. No. 73-2360 at 7, *quoting* Hampton v. Spindale, 210 N.C. 546, 548, 187 S.E. 775, 776 (1936).
17. No. 73-2360 at 7.
18. Violation of a city ordinance is a misdemeanor. N.C. GEN. STAT. § 14-4 (1969). In defense, Schlitz pointed out that the city's officials did not require compliance with the ordinance until a year after the sewage ordinance became effective. However, the court ruled that while the ordinance "recognized that compliance was not instantly attainable and allowed city officials to furnish technical assistance and advice, its terms gave them no power to affect the rights of third parties." No. 73-2360 at 10-11.

The following is a time table of key events:
July 1, 1969—Brewery began production. At that time, there was no sewage ordinance or limitation placed by the city on the quality or quantity of water.
February 2, 1970—Sewage ordinance was enacted.
May 1970—Sewage ordinance became effective and city started billing and Schlitz paying BOD surcharges.
June 11, 1970—Schlitz was first advised of ordinance and of the necessity of obtaining a permit.
Spring and Summer, 1970—The six unprecedented fish kills occurred on the Yadkin River.
April 1971—At this point Schlitz's waste stopped containing more than 2500 ppm BOD

for damages caused to downstream riparian owners.[19]

In addition, the court felt that this liability for violation of the ordinance was mandated by State law and held the violator of a statute "designed to protect persons or property" liable for damage proximately caused by such violation.[20] The court's position appears to be adequately supported by North Carolina case law.

In *Carr v. Murrows Transfer, Inc.*[21] the North Carolina Supreme Court ruled that "violation of a statute enacted for the safety and protection of the public constitutes negligence per se. . . . [W]here a . . . municipal ordinance imposes . . . a specific duty for the protection or benefit of others," failure to perform that duty creates a cause of action in "those whose protection or benefit it was imposed for."[22]

Moreover, the court, in *Town of Shelby v. Cleveland Mill & Power Co.*,[23] held that the State could not divest itself of the right to exercise its police power for the general good. Therefore, the court concluded that the defendant corporation could not acquire a prescriptive right to dump its untreated sewage into a river. In this same vein, the Fourth Circuit held that the city's desire to mitigate potential economic losses caused by closing the brewery could not override private rights.[24] Thus, if Schlitz were allowed to continue operation, it would have to bear the responsibility for damages caused by extension of the compliance schedule.[25] The court's position is strengthened by a 1972 amendment to the ordinance authorizing the city to suspend the requirements of section 23-2(2).[26] If such action

(the limit set by the city ordinance).
May 1971—Schlitz received permit.
1972—Winston-Salem Ordinance was amended explicitly to authorize the city to suspend its requirements.

19. No. 73-2360 at 7.

20. *Id.* at 8, *citing* Murray v. Bensen Aircraft, 259 N.C. 638, 642, 131 S.E.2d 367, 370 (1963).

21. 262 N.C. 550, 138 S.E.2d 228 (1964).

22. *Id.* at 554, 138 S.E.2d at 231.

23. 155 N.C. 196, 71 S.E. 218 (1911).

24. No. 73-2360 at 11.

25. *Id.* at 11-12.

26. This point was the main basis of Judge Widener's dissent. He felt that "no violation of the sewer use ordinance was shown because of the construction placed on the ordinance by the city." *Id.* at 23. He supports his position by citing the general rule that "when dealing with the interpretation of an ambiguous city ordinance one must consider contemporaneous interpretation of the ordinance by city officials. . . ." *Id.* at 27. The problem with this theory is that section 23-2(2), the ordinance in question, is quite clear and unambiguous on its face. *See* note 4 *supra.* North Carolina generally holds that where the terms of a statute are clear, no interpretation is required. Peele v. Finch, 284 N.C. 375, 200 S.E.2d 635 (1973); Lutz v. Gaston County Bd. of Educ., 282 N.C. 208, 192 S.E.2d 463 (1972).

had been possible earlier, arguably, there would have been no need for the amendment.[27]

Evaluating the second exception,[28] the court resorted to "an analysis of the underlying reasons for the general rule of immunity."[29] The North Carolina Supreme Court, in *Hampton* and *Clinard*, had looked to the leading case in the area, *Carmichael v. Texarkana*.[30] In *Carmichael*, a riparian landowner sued the city and its inhabitants for polluting water adjacent to his property. In ruling that the inhabitants were not liable for the damage caused by the sewage system, the Eighth Circuit had compared the relationship of the user of a sewage system and the city to that of an employer and an independent contractor:

> If [the inhabitants] had taken their own sewage to the creek, and poured it into its waters above the premises of the complainants, they would undoubtedly . . . have been liable . . . . On the other hand, if they had made an agreement with an independent contractor . . . to remove all their sewage from their premises to a place where, and in a manner in which, it could do no unnecessary injury to any one, and their contractor had carelessly deposited it . . . in the stream above [complainants'] property, the [inhabitants] would not have been liable for these wrongful acts of their contractor. Their relation to the city and its negligence is not of a different character.[31]

Thus, the court concluded that if one has the power to command or control the performance of the action in question, then one is liable for resulting damage.[32] Although no North Carolina case has employed the analogy made by *Carmichael*, the idea of control as a test for liability has been accepted.[33]

The Fourth Circuit next examined North Carolina law governing the relationship between employer and independent contractor. The North Carolina Court of Appeals has stated that:

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27. No. 73-2360 at 11 & n.11.

28. *See* text accompanying note 4 *supra*.

29. No. 73-2360 at 13.

30. Carmichael v. Texarkana, 116 F. 845 (8th Cir. 1902). *Springer* likewise focused on *Carmichael*. No. 73-2360 at 14.

31. No. 73-2360 at 14, *quoting* Carmichael v. Texarkana, 116 F. 845, 849 (8th Cir. 1902).

32. 116 F. at 850.

33. In *Clinard* the court said, "The [polluter] has no control over the disposition of the water. It is disposed of under the sole supervision and control of the defendant town. Under such circumstances no liability is imposed upon [the polluter] for any damage caused to the property of the plaintiffs on account of the emptying of such dye water . . . ." 215 N.C. at 748, 3 S.E.2d at 270, *citing* Carmichael v. Texarkana, 116 F. 845 (8th Cir. 1902).

> [Generally,] an employer . . . is not liable for the torts of an independent contractor committed in the performance of the contracted work. However, a condition prescribed to relieve an employer from liability for the negligent acts of an independent contractor employed by him is that he shall have exercised due care to secure a competent contractor for the work. Therefore, if it appears that the employer either knew or by the exercise of reasonable care might have ascertained that the contractor was not properly qualified to undertake the work, he may be held liable for the negligent acts of the contractor.[34]

The Fourth Circuit reasoned that industrial sewage sources, being "similarly situated,"[35] must likewise exercise due care in selecting a municipal disposal system.[36] Thus, since Schlitz controlled the "selection of a site and of the sewage system which would dispose of its waste" and since it knew, or should have known, that Winston-Salem could not treat its sewage, the court concluded that Schlitz was not immune.[37]

The impact of *Springer* can be fully appreciated only after a consideration of the Federal Water Pollution Control Act Amendments of 1972.[38] Although prior legislation had dealt with the problem of water pollution the situation was not improving, and Congress passed the amendments to alleviate this problem.[39] In this new Act, "for the first time, Congress has declared water pollution illegal."[40] "[T]he regulatory core of the new . . . program consists of the discharge permit . . . [that] in turn is based upon compliance with various effluent standards promulgated by EPA."[41] Section 1317, Toxic and Pretreatment Effluent Standards, has a provision dealing specifically with discharges by persons and corporations into municipal sewage treatment

34. Page v. Sloan, 12 N.C. App. 433, 439, 183 S.E.2d 813, 817 (1971), *aff'd*, 281 N.C. 697, 190 S.E.2d 189 (1972).

35. No. 73-2360 at 16.

36. The corporation is in the best position to know potential sewage production and to investigate the capability of the city system. *Id.* at 17.

37. *Id.* at 18-19.

38. 33 U.S.C. §§ 1251-1376 (Supp. II 1972).

39. The new legislation, "although technically amending the Federal Water Pollution Control Act of 1965, for all practical purposes replaced all federal water pollution control statutes." McThenia, *An Examination of the Federal Water Pollution Control Act Amendments of 1972*, 30 WASH. & LEE L. REV. 195, 202 (1973).

40. *Id.* at 196. "[I]n order to implement this basic decision that the nation's waters are not to be used for waste disposal, Congress established (a) a regulatory and enforcement strategy in the traditional administrative agency mold and (b) a system of subsidies to localities to permit them to achieve the goals of the Act." *Id.* at 197.

41. Comment, *Judicial Review and the 1972 Amendments to the Federal Water Pollution Control Act: And Who Shall Guard the Guards?*, 68 NW. U.L. REV. 770, 776 (1973).

facilities.[42] Section 1319, Enforcement, provides a remedy for violation of effluent limitations,[43] pretreatment standards, or permit conditions.[44] The provision limits the administrator to seeking an injunction[45] or a civil penalty in the form of a specified series of fines.[46] The Act makes no provision for damages. In section 1365, the Act also allows any citizen to commence a civil action against anyone allegedly in violation of an effluent standard or limitation or an order issued by the administrator or a state regarding that standard or limitation.[47] District courts are given jurisdiction over such actions and can issue an injunction enforcing the effluent standard or limitation or order and can allow recovery of civil penalties available under section 1319(d).[48] In addition, the court "may award costs of litigation to any party whenever the court determines such award is appropriate."[49] There is, however,

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42. Section 1317 provides for establishment of specific effluent limitations and pretreatment standards and makes it unlawful to operate in violation of such standards. The pertinent provisions of section 1317 are as follows:

> (b)(1) The Administrator shall . . . publish proposed regulations establishing pretreatment standards for introduction of pollutants into treatment works . . . which are publicly owned for those pollutants which are determined not to be susceptible to treatment by such treatment works or which would interfere with the operation of such treatment works. Not later than 90 days after publication, and after opportunity for public hearing, the Administrator shall promulgate such pretreatment standards. Pretreatment standards . . . shall be established to prevent the discharge of any pollutant through treatment works which are publicly owned, which pollutant interferes with, passes through, or otherwise is incompatible with such works.
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> . . . .
>
> (d) After the effective date of any effluent standard or prohibition or pretreatment standard promulgated under this section, it shall be unlawful for any owner or operator of any source to operate any source in violation of any such effluent standard or prohibition or pretreatment standard.

33 U.S.C. §§ 1317(b)(1), (d) (Supp. 1972).

43. Effluent limitations are defined by section 1362(11) as "any restriction established by a State or the Administrator on quantities, rates, and concentrations of chemical, physical, biological, and other constituents which are discharged from point sources into navigable waters, . . . including schedules of compliance." *Id.* § 1362(11).

44. The pertinent provisions of section 1319 are as follows:

> (a)(3) Whenever . . . the Administrator finds that any person is in violation of section 1311, 1312, 1316, *1317*, or 1318 of this title or is in violation of any permit condition or limitation . . . issued under section 1342 of this title . . . , he shall issue an order requiring such person to comply with such section or requirement, or he shall bring a civil action in accordance with subsection (b). . . .
>
> (b) The Administrator is authorized to commence a civil action for appropriate relief, including a permanent or temporary injunction, for any violation for which he is authorized to issue a compliance order . . . .

Id. § 1319 (emphasis added).

45. *Id.* § 1319(b).

46. *Id.* §§ 1319(c)(1), (d). "[I]f the state does not act with dispatch, the Administrator is compelled to seek injunctive relief." McThenia, *supra* note 31, at 204.

47. 33 U.S.C. § 1365(a)(1) (Supp. 1972).

48. *Id.* § 1365(a).

49. *Id.* § 1365(d).

no mention of damages.[50]

The existence of this legislation diminishes the impact of *Springer* because the Act allows a private individual to sue the polluting corporation. Therefore, that portion of the decision allowing such a cause of action is insignificant *if* there is a violation of the federal Act. *Springer* does, however, fill numerous gaps in the federal legislation. First, in diversity actions governed by North Carolina law, *Springer* provides for damages as an alternative to the federal remedies of injunction and civil penalties. The significance of this distinction becomes clearer when one considers the reluctance of most courts to issue injunctions, especially those which might cause factory closings.[51] Hopefully, the courts will not be as reluctant to force industrial polluters to pay for the damage they have caused.[52] More significantly, *Springer* offers a remedy for persons damaged by industrial polluters not in violation of the federal Act. This is notable because of the likelihood that there will be numerous cases of pollution without violation of the federal Act.[53] Finally, *Springer* is significant in revealing the Fourth Circuit's determination to enforce water pollution legislation and to place the burden of responsibility for pollution on those who create it.

The strength of pollution legislation lies in the attitude of those enforcing it.[54] There have been problems in the past, not with the availability of the legislation, but with its enforcement.[55] Even if the EPA forces compliance, it could be in the form of a compliance sched-

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50. Nothing in section 1365 cuts off any other cause of action available under any statute or common law to get enforcement or any other relief. *Id.* § 1365(e).

51. *See* D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES § 5.7, at 360-61 (1973).

52. Although the federal Act does provide civil penalties, it seems that these will go to the federal government, not the private litigants. In addition, damages would bear a closer relation to the actual injury suffered by the plaintiff.

53. Because the EPA [Environmental Protection Agency] will undoubtedly want to minimize the number of plants forced to close by the application of federal effluent standards, these standards will be sufficiently lenient so that only the most inefficient and polluting facilities will be unable to meet them. . . . Nothing on the face of the 1972 Amendments compels the EPA to require an individual plant to exceed the effluent standards, even in the event that the water into which the plant discharges will remain polluted.

Comment, 68 NW. U.L. REV., *supra* note 43, at 781.

54. " 'The key to an effective regulatory system is that there be firm, specific requirements imposed on all parties. . . . The exact requirements . . . must . . . be *uniformly and strictly enforced*.' " Comment, *The Federal Water Pollution Control Act Amendments of 1972*, 14 B.C. IND. & COM. L. REV. 672, 707-08 (1973), *quoting* Statement of John Quarles, Jr.

55. As one commentator observed:

[I]f past federal water pollution control efforts are any guide, there is reason to believe that the EPA will fall significantly short of the goals set by Congress. . . . [T]he Executive has consistently avoided strict enforcement of existing pollution law. Comment, 68 NW. U.L. REV., *supra* note 43, at 786.

ule such as the one in *Springer*. The industry, although in compliance with the federal Act and the EPA, could still pollute the water for several years, causing damage to riparian landowners. In such situations, *Springer* provides a solution by requiring the polluter to pay damages while also allowing the company to continue operation.[56] Thus, *Springer* acts as an additional deterrent to industrial pollution. Finally, *Springer* provides an important incentive to citizen action. Although the federal Act provides for injunction and costs of litigation in some cases, there is no provision for compensation of damages suffered by plaintiffs. Citizens who know they can recover damages hopefully will be encouraged to sue polluters. With these factors in mind, it becomes obvious that *Springer* will play an important role in control of water pollution.

Of course, the attitude of the North Carolina courts will be critical. The North Carolina Supreme Court recently observed that:

> Beyond any doubt air and water pollution have become two of modern society's most urgent problems . . . . Regardless of where it occurs, the abatement and control of environmental pollution are immediately necessary to public health, safety, and general welfare; and, in the exercise of the State's police power, the legislature has plenary authority to abate and control pollution of all kinds.[57]

This statement is dicta, but it does show a willingness on the part of the court to consider environmental factors. In a case such as *Springer*, the ultimate question is whether to place the cost of damages on the taxpayers or the polluting industry and its consumers. In keeping with the national policy exhibited in the federal amendments of 1972, it would seem that the polluter should pay. If the North Carolina Supreme Court follows the lead of *Springer*, the case will become a viable legal instrument to be used in deterring water pollution.

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56. No. 73-2360 at 12.

57. Stanley v. Department of Conservation & Dev., 284 N.C. 15, 36-37, 199 S.E.2d 641, 655 (1973).

Fair Trade—Resale Price Maintenance: North Carolina Fair Trade Act Held Unconstitutional As Applied to Nonsigners

The North Carolina Fair Trade Act[1] permits certain retail price fixing by manufacturers and retailers and eliminates intrabrand competition in the retail market. A fair trade agreement between a manufacturer and retailer typically states that the retailer will not sell or offer for sale certain products at prices below those set by the manufacturer, who in turn reserves the right to change list prices at will.[2] The manufacturer agrees to enforce the agreement against anyone who sells such products below the set price levels.[3] North Carolina's Fair Trade Act not only provides that such agreements are enforceable as between the parties to the contract, but also permits these fixed retail prices to be enforced against sellers who have never agreed to "fair trade" the goods and who obtained their inventory from persons likewise free of any such obligation.[4] This nonsigner clause is generally regarded as the key to effective fair trade enforcement due to the enormous expense involved in executing fair trade contracts with every retailer in

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1. N.C. GEN. STAT. §§ 66-50 to -57 (1965). Section 66-52 provides:

> No contract relating to the sale or resale of a commodity which bears, or the label or container of which bears, the trademark, brand, or name of the producer or distributor of such commodity and which commodity is in free and open competition with commodities of the same general class produced or distributed by others, shall be deemed in violation of any law of the State of North Carolina by reason of any of the following provisions which may be contained in such contract:
>
> (1) That the buyer will not resell such commodity at less than the minimum price stipulated by the seller.
>
> (2) That the buyer will require of any dealer to whom he may resell such commodity an agreement that he will not, in turn, resell at less than the minimum price stipulated by the seller.
>
> (3) That the seller will not sell such commodity:
>
> a. To any wholesaler, unless such wholesaler will agree not to resell the same to any retailer unless the retailer will in turn agree not to resell the same except to consumers for use and at not less than the stipulated minimum price, and such wholesaler will likewise agree not to resell the same to any other wholesaler unless such other wholesaler will make the same agreement with any wholesaler or retailer to whom he may resell; or
>
> b. To any retailer, unless the retailer will agree not to resell the same except to consumers for use and at not less than the stipulated minimum price.

2. *See, e.g.*, 2 TRADE REG. REP. ¶¶ 6051-52 (suggested model manufacturer/retailer and manufacturer/wholesaler contracts).

3. *Id.*

4. N.C. GEN. STAT. § 66-56 (1965). This section reads: "Willfully and knowingly advertising, offering for sale or selling any commodity at less than the price stipulated in any contract entered into pursuant to the provisions of this article, *whether the person so advertising, offering for sale or selling is or is not a party to such contract,* is unfair competition and is actionable at the suit of *any* person damaged thereby." *Id.* (emphasis added).

the State.[5] This controversial nonsigner clause, however, was recently struck down by the North Carolina Supreme Court in *Bulova Watch Co. v. Brand Distributors, Inc.*[6]

In reaching its conclusion the court was compelled to reverse an earlier long-standing decision,[7] overcoming the inertia of its traditional and deeply-rooted commitment to *stare decisis*.[8] The Court's turnabout on virtually indistinguishable facts is somewhat perplexing, and perhaps can be explained only as a definitive judicial response to an almost irresistible shift in policy on both the national and local levels.

THE DEVELOPMENT OF RESALE PRICE MAINTENANCE LAW

In 1911 express fair trade contracts to maintain the resale price of goods in *interstate* commerce were declared unenforceable by the United States Supreme Court as violations of the Sherman Antitrust Act.[9] In *Dr. Miles Medical Co. v. John D. Park & Sons Co.*[10] the Court held that such contracts amounted to illegal price-fixing by manufacturers, that they were unenforceable restraints upon trade, and were void as against public policy as manifested both by the common law and by federal statutes.[11] This decision, however, did not prevent the States from enacting fair trade legislation applicable to purely *intrastate* transactions, and, beginning with California in 1931, the vast majority of States eventually enacted fair trade acts.[12] The fair trade movement gained considerable impetus in 1936 when the United States Supreme

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5. *See* Shearin, *North Carolina Fair Trade Act*, 8 WAKE FOREST L. REV. 45, 51 (1971).

6. 285 N.C. 467, 206 S.E.2d 141 (1974).

7. Ely Lilly & Co. v. Saunders, 216 N.C. 163, 4 S.E.2d 528 (1939).

8. "This Court has never overruled its decisions lightly. No court has been more faithful to *stare decisis*." Rabon v. Rowan Memorial Hosp., 269 N.C. 1, 20, 152 S.E.2d 485, 498 (1967) (Sharp, J.).

9. 15 U.S.C. § 1 (1970) (originally enacted as Act of July 2, 1890, ch. 647, 26 Stat. 209).

10. 220 U.S. 373 (1911).

11. Whatever right the manufacturer may have to project his control beyond his own sales must depend, not upon an inherent power incident to production and original ownership, but upon agreement.

. . . .

But agreements or combinations between dealers, having for their sole purpose the destruction of competition and the fixing of prices, are injurious to the public interest and void. . . .

. . . .

. . . The complainant having sold its product at prices satisfactory to itself, the public is entitled to whatever advantage may be derived from competition in the subsequent traffic.

Id. at 405-09.

12. 2 TRADE REG. REP. ¶ 6017.

Court upheld the nonsigner provisions of fair trade acts in California and Illinois.[13] In 1937 North Carolina enacted a Fair Trade Act that included a nonsigner clause.[14]

In the meantime, developments at the federal level reflected the popular trend. In 1937 Congress passed the Miller-Tydings Amendment[15] to section 1 of the Sherman Act,[16] in effect overruling *Dr. Miles*[17] and thereby legalizing resale price maintenance contracts on products sold in interstate commerce.[18] In 1951, however, the Supreme Court in *Schwegman Brothers v. Calvert Distillers Corp.*[19] construed the Miller-Tydings Amendment narrowly to exclude from its protection the popular nonsigner provisions of state fair trade laws.[20] Congress responded in 1952 with the McGuire Act,[21] which specifically allows enforcement of resale price agreements against nonsigners when permitted by state law. The result of these two acts has been to grant

13. Old Dearborn Distrib. Co. v. Seagram-Distillers Corp., 299 U.S. 183 (1936). This decision meant that fair trade contracts were valid under the federal antitrust laws as applied to goods moving strictly in commerce within a state, providing of course that such contracts were enforceable under state law. Goods moving across state lines could not be subjected to fair trade contracts under the Supreme Court's interpretation of the Sherman Act in Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911). *See also* excerpts from Report by the Federal Trade Commission on Resale Price Maintenance (Dec. 13, 1945), *reprinted in* 2 TRADE REG. REP. ¶ 6017.75.

14. N.C. GEN. STAT. §§ 66-50 to -57 (1965). *See also A Survey of Statutory Changes in North Carolina in 1937*, 15 N.C.L. REV. 321, 367 (1937).

15. Ch. 690, 50 Stat. 693 (1937).

16. 15 U.S.C. § 1 (1970) (originally enacted as Act of July 2, 1890, ch. 647, 26 Stat. 209).

17. *See* note 11 and accompanying text *supra.*

18. "The Miller-Tydings Amendment . . . is a federal enabling statute which legalizes vertical minimum resale price maintenance contracts or agreements for trademarked commodities sold in any state which legalizes such contracts with respect to intrastate sales." S. OPPENHEIM & G. WESTON, UNFAIR TRADE PRACTICES AND CONSUMER PROTECTION: CASES AND COMMENTS 752 (3d ed. 1974).

19. 341 U.S. 384 (1951).

20. Writing for the majority, Justice Douglas held that, when Congress exempted fair trade "contracts" from the antitrust laws with the Miller-Tydings Amendment, the word "contract" must be construed to presume a consensual agreement between the parties thereto. *Id.* at 388. The Louisiana statute under attack, however, contained the usual nonsigner clause. *Id.* Justice Douglas reasoned that "certainly the words used [in the Miller-Tydings Amendment] connote a voluntary scheme . . . not a program whereby recalcitrants are dragged in by the heels and compelled to submit to price fixing." *Id.* at 390. Where a fixed retail price is sought to be enforced against nonsigners, Douglas continued, there is lacking the important "contractual" relationship essential to the Miller-Tydings exemption. Had Congress intended to include nonsigner provisions, Douglas concluded, it would have done so expressly. *Id.*

21. Ch. 754, 66 Stat. 632 (1952). "Like the Miller-Tydings Amendment, [the McGuire Act] is merely a federal enabling statute which does not represent federal approval, or disapproval, of resale price maintenance." S. OPPENHEIM & G. WESTON, *supra* note 18, at 752.

effective federal antitrust exemptions to fair trade practices under state or local laws.[22]

In the 1950's popular sentiment began to turn against fair trade.[23] A number of state courts have held fair trade acts invalid on state, not federal, constitutional grounds.[24] Nonsigner clauses have been particularly vulnerable to constitutional attack, primarily on three gounds: (a) that the clauses represent an unconstitutional delegation of legislative power,[25] (b) that they deny nonsigners due process of law,[26] and (c) that they are an improper exercise of a state's police power for the benefit of solely private interests.[27] Latest available statistics show that nonsigner clauses in thirty-two states have been either held unconstitu-

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22. 2 TRADE REG. REP. ¶¶ 6025-27.

23. *Id.* at ¶ 6021.

24. *Id. See also* Note, *Restraint of Trade—Fair Trade Acts—Constitutionality*, 31 N.C.L. REV. 509 (1953).

25. *See, e.g.*, Dr. G.H. Tichenor Antiseptic Co. v. Schwegmann Brothers Giant Super Markets, 231 La. 51, 90 So. 2d 343 (1956):

> It is fundamental "that legislative power, conferred under constitutional provisions, cannot be delegated by the Legislature either to the people or to any other body or authority." . . . [C]ourts will not hesitate to strike down legislation vesting in private persons the right to determine the state of things upon which the effect of the law depends as this is legislative delegation in its most obnoxious form. . . .
>
> . . . .
>
> . . . [Under the Fair Trade Act], there is an unlawful delegation of power because it is the manufacturer or producer who fixes minimum price and not the Legislature itself . . . .

Id. at 63-66, 90 So. 2d at 347-48. *See also* 2 TRADE REG. REP. ¶¶ 6021.01-.54.

26. *See, e.g.*, Olin Mathieson Chem. Corp. v. Francis, 134 Colo. 160, 301 P.2d 139 (1956):

> The right to contract is a property right, protected by the due-process clause of the constitution . . . .
>
> . . . .
>
> To the extent that the Colorado Act is coercive it is lacking in due process, is confiscatory, and tends to establish a monopoly. . . .
>
> . . . .
>
> Any act of the General Assembly which arbitrarily destroys or impairs the right of the individual to the free use and enjoyment of his property, lawfully acquired, and permits the fixing of prices for the benefit of a special group, is opposed to the constitutional concept of a free people and should not be allowed to stand.

Id. at 176-86, 301 P.2d 147-52. *See also* 2 TRADE REG. REP. ¶¶ 6021.01-.54.

27. *See, e.g.*, Shakespeare Co. v. Lippman's Tool Shop Sporting Goods Co., 334 Mich. 109, 54 N.W.2d 268 (1952):

> The consideration of whether the price fixing be vertical, horizontal, or even diagonal, or whether the regulation relates to all of a certain type of commodity . . . , although relevant when the question of monopoly needs to be determined, is of no consequence in determining . . . whether the statute in question, as applied to nonsigners, bears any reasonable relation to public health, safety, morals or the general welfare. . . . If the act does not bear the mentioned relationship, . . . it cannot be sustained as a lawful exercise of the state's police power, . . . and it is our duty to deny such enforcement and brand the act for what it is, unconstitutional.

Id. at 114-115, 54 N.W.2d at 270. *See also* 2 TRADE REG. REP. ¶¶ 6021.01-.54.

tional by state courts or repealed by the legislatures.[28] At present only thirteen states have fair trade acts with nonsigner provisions valid under state law.[29] As one observer has noted, "the passage of time has shown [resale price maintenance] to be of little value to anyone except retailers who desire to fix prices in order to pad their profit margins."[30]

NORTH CAROLINA FAIR TRADE AND THE COURTS

Prior to *Bulova Watch* the constitutionality of North Carolina's Fair Trade Act had been challenged in only three reported cases.[31] In the landmark case of *Ely Lilly & Co. v. Saunders*[32] the decision was clear and unequivocal: the Act, including the nonsigner clause was held valid under the North Carolina constitution. In that case defendant had sold goods manufactured by plaintiff at less than the fair trade price. While plaintiff had executed contracts with a number of retailers, defendant was in all respects a nonsigner. Plaintiff sought an injunction under the nonsigner clause to prevent further price-cutting by defendant. Finding for plaintiff, the supreme court rejected defendant's claims that the statute tended to create a monopoly, that the law deprived him of his property rights in the goods sold without due process of law, that the law was an improper delegation of legislative power to private persons, and that the statute was an illegal special or local law regulating trade, all in violation of various sections of the State constitution.[33]

On the eve of *Bulova Watch*, then, the matter seemed settled. Nonsigners were well-advised to address their complaints to the General Assembly in hopes that the law might be changed, rather than wasting their time litigating a foregone conclusion. Two nonsigners

28. 2 TRADE REG. REP. ¶ 6041.

29. *Id.*

30. Shearin, *supra* note 5, at 62-63.

31. Subsequent to Ely Lilly & Co. v. Saunders, 216 N.C. 163, 4 S.E.2d 528 (1939), the constitutionality of the nonsigner clause of the Fair Trade Act was challenged in Union Carbide Corp. v. Davis, 253 N.C. 324, 116 S.E.2d 792 (1960). There the State attorney general filed an *amicus curiae* brief requesting that the North Carolina Supreme Court declare the Act unconstitutional. The case was ultimately resolved on other grounds, however, and the constitutional argument was never reached. *See, e.g.*, Shearin, *supra* note 5, at 54-55.

In 1962 a case arose on diversity in federal district court in which the validity of the nonsigner clause was again questioned. In Parker Pen Co. v. Dart Drug Co., 202 F. Supp. 646 (M.D.N.C. 1962), Judge Preyer felt bound by Ely Lilly & Co. v. Saunders, *supra*, and granted plaintiff's motion for an injunction under the nonsigner clause.

32. 216 N.C. 163, 4 S.E.2d 528 (1939).

33. Justice Barnhill disagreed in a fierce dissent which reverberates between the lines throughout the opinion in *Bulova Watch*. *Id.* at 182-97, 4 S.E.2d at 541-50.

who failed to heed this advice were a pair of North Wilkesboro discount jewelers.

BULOVA WATCH CO. V. BRAND DISTRIBUTORS, INC.

Over the years the Bulova Watch Company has induced a number of merchants throughout the nation to sign fair trade agreements for its watches.[34] Bulova executed such contracts with several North Carolina dealers,[35] and under the State Fair Trade Act these agreements gave Bulova the right to compel all other retailers to sell watches at the company-set price.[36] Brand Distributors, Inc. and Motor Market, Inc. felt that they could sell Bulova merchandise at prices considerably below list and still realize a reasonable profit satisfactory to themselves.[37] To avoid Bulova's fair trade contracts, these two merchants did not obtain goods from Bulova directly, but instead purchased new watches at bankruptcy sales[38] and from other parties not bound by fair trade agreements with Bulova.[39] Brand Distributors and Motor Market sold these watches for less than the fair trade price, and Bulova sued in superior court to enjoin future cut-rate sales. The superior court granted the injunction, and the court of appeals reluctantly affirmed,[40]

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34. The West Publishing Company's national reporter system bears convincing witness of Bulova's litigiousness in enforcing these agreements against signers and nonsigners alike. *See, e.g.*, Bulova Watch Co. v. Zale Jewelry Co., 274 Ala. 270, 147 So. 2d 797 (1962); Bulova Watch Co. v. Robinson Wholesale Co., 252 Iowa 740, 108 N.W.2d 365 (1961); Bulova Watch Co. v. Ontario Store, Inc., 18 Ohio Op. 2d 221, 176 N.E.2d 527 (Franklin County C.P. 1961); Zale-Las Vegas, Inc. v. Bulova Watch Co., 80 Nev. 483, 396 P.2d 683 (1964); Bulova Watch Co. v. Zale Jewelry Co., 371 P.2d 409 (Wyo. 1962).

35. "By such agreement the retailer agrees not to sell or offer for sale any watch or other article, bearing the plaintiff's brand or trade name, at a price different from that shown on a retail price list compiled and furnished by the plaintiff, who reserves the right to change the listed prices from time to time. The agreement further provides that the plaintiff agrees to employ all reasonable and lawful means, including legal action, to obtain and enforce general observance of such prices by retailers." 285 N.C. at 468, 206 S.E.2d at 142.

36. *See* notes 1-4 and accompanying text *supra*.

37. *See generally* Defendant Appellants' Supplemental Brief at 2-5, Bulova Watch Co. v. Brand Distribs., Inc., 285 N.C. 467, 206 S.E.2d 141 (1974).

38. *Id.* at 468, 206 S.E.2d at 143. Note that under the North Carolina Fair Trade Act, trustee-vendors at bankruptcy sales are not bound to sell fair trade merchandise at the fixed price. N.C. GEN. STAT. § 66-55(4) (1965).

39. N.C. GEN. STAT. § 66-55(4) (1965).

40. Bulova Watch Co. v. Brand Distribs., Inc., 20 N.C. App. 648, 202 S.E.2d 350 (1974). "More than thirty-four years ago, our Supreme Court, Justice Barnhill dissenting, held that the 'Fair Trade Act' was valid and constitutional. . . . Until that opinion is modified or superseded by the Supreme Court, we are bound by it, although we consider much of defendant's argument to be sound." *Id.* at 649, 202 S.E.2d at 350-51 (Vaughn, J.).

feeling itself bound by the *Ely Lilly* decision.[41] The North Carolina Supreme Court granted certiorari to reassess its decision in that prior case.[42]

Defendants attacked the nonsigner clause in much the same fashion as had their counterpart in *Ely Lilly*.[43] They contended that the statute was invalid as applied to non-signers in that (a) it delegates legislative power to a private corporation in violation of article II, section 1 of the North Carolina constitution,[44] and (b) it deprives nonsigners of liberty without due process of law in violation of article I, section 19.[45]

The court was clearly on firmer ground in its analysis of the first proposition. Justice Lake correctly noted that the General Assembly in limited circumstances has the power to fix retail prices in the public interest and that this power cannot be delegated to private interests.[46] Yet the nonsigner provision of the Fair Trade Act permitted one private party, the manufacturer, to fix prices arbitrarily and enforce them against other private parties with whom he had no commercial or contractual relationship.[47] The court was clearly struck by the absolute power of the manufacturer to raise or lower at will his statewide fixed prices, with no legislatively prescribed standards or criteria to regulate these changes in price.[48] Moreover, the court's unease was compounded by its realization that, under the Fair Trade Act, statewide resale price maintenance can be achieved through the execution of a single fair trade contract to which all retailers in the State would become bound.[49]

The opinion takes pains to point out the error of *Ely Lilly* on the matter of delegation of legislative power. In the prior case the court had relied upon a "restrictive covenant" theory to hold that, once an article in commerce had been impressed by the manufacturer with a fixed resale price, this fixed price "ran with" the product into the

41. See notes 32-33 and accompanying text *supra*.
42. 285 N.C. at 471, 206 S.E.2d at 144.
43. *See* notes 32-33 and accompanying text *supra*.
44. Defendant Appellants' Supplemental Brief at 5.
45. *Id.*
46. 285 N.C. at 475, 206 S.E.2d at 147-48.
47. *See* notes 1-4 and accompanying text *supra*.
48. "The price so fixed need have no relation to the cost to such retailer, to a reasonable profit to him or to any other standard. When so fixed, it is subject to change by the producer at will from time to time and with no right in any retailer to be heard by anyone." 285 N.C. at 476, 206 S.E.2d at 147.
49. *Id.* at 475, 206 S.E.2d at 147-48.

hands of the nonsigner retailer.[50] Thus, explained the court in *Ely Lilly*, the legislature had delegated nothing, for the retail price was an inseparable characteristic of the product itself and "ran with" it through all levels of the marketing process.[51] This restrictive covenant theory was rejected in *Bulova Watch* as inapplicable to the case at bar.[52] Nothing in the record indicated that defendants had purchased any Bulova merchandise which had been originally "impressed" with a factory-set resale price, and indeed there was evidence that defendants' vendors were not bound by any fair trade obligations.[53] Therefore, the restrictive covenant theory could not support the statute.[54]

The nonsigner clause of the North Carolina Fair Trade Act was thus unequivocally held unconstitutional as an improper delegation of legislative power. The court should have ended its inquiry here. Yet quite unnecessarily the opinion proceeded to the second of defendant's contentions, that the statute deprived nonsigners of "liberty" under article I, section 19 of the State constitution. In so doing, the court drifted away from the careful, well-reasoned jurisprudence of preceding paragraphs and tumbled recklessly into the realm of partisan politics. The court's discussion of this latter issue reads more like an exercise in advocacy journalism than a landmark decision by a state court of last resort.

The court began with a sweeping statement of its constitutional duty to declare acts of the General Assembly unconstitutional when they unjustifiably restrict one's freedom to use and enjoy private property.[55] The constitutional fate of the Fair Trade Act was thus made to hang in the balance between personal liberty and public benefit. The court left no doubt who would do the balancing.

Offering but a nod of deference to the General Assembly, the court relied upon its "advantage of access to another page of history"[56] in reflecting upon the shifting policy considerations and needs of the contemporary marketplace. Quoting the *Wall Street Journal*,[57] pointing

50. 216 N.C. at 176-77, 4 S.E.2d at 537-38.
51. *Id.*
52. 285 N.C. at 476, 206 S.E.2d at 148.
53. *Id.* at 476-77, 206 S.E.2d at 148.
54. *Id.*
55. *Id.* at 478, 206 S.E.2d at 149.
56. *Id.*
57. *Id.* at 479, 206 S.E.2d at 149.

to judicial hostility toward nonsigner clauses in other states,[58] and relying upon its own economic analysis of the anticompetitive effects of vertical and horizontal price fixing,[59] the court concluded that the freedom of contract of nonsigners outweighed any public benefit derived from the statute.[60]

Bulova Watch raises serious questions of separation of powers, and is certain to be viewed by some as judicial legislation in its most blatant form, particularly since the General Assembly has consistently refused to repeal fair trade legislation of some thirty-eight years' standing.[61]

In all fairness, there are few who will mourn the passing of resale price maintenance in North Carolina. Enacted originally to protect the property interests of manufacturers in trademarked goods, state fair trade laws have succeeded only in permitting legalized price fixing by retailers at the consumer's expense.[62] America's experiment with resale price maintenance is an idea whose time has come and gone again, and the national trend indicates that state fair trade acts have far outlived their usefulness.[63] The demise of fair trade in North Carolina will undoubtedly benefit consumers, for there should emerge greater competition and lower prices for high quality, brand name merchandise. In addition, North Carolina now joins what is without doubt the national mainstream in opposition to resale price maintenance.[64] These policy considerations weighed heavily in the court's balancing test in *Bulova Watch.*

CONCLUSION

In holding the nonsigner provision of North Carolina's Fair Trade Act unconstitutional, the State supreme court has most likely rung the

58. *Id., quoting* Corning Glass Works v. Ann & Hope, Inc., — Mass. —, 294 N.E.2d 354 (1973).

59. *Id.* at 480-81, 206 S.E.2d at 150.

60. *Id.* at 481, 206 S.E.2d at 151.

61. Contemplation of this latter half of the opinion in *Bulova Watch* inspires in one the nagging suspicion that the matters there discussed and the conclusions drawn therefrom might more appropriately arise in the committee rooms of the General Assembly rather than in the splendid isolation of chambers of court. Whenever the court strikes down an act of the General Assembly, there are those who object that the court is in effect usurping the powers of the legislative branch. These troublesome concepts of substantive due process are beyond the scope of this case note, but are discussed skillfully and at length in Comment, *Hospital Regulation After Aston Park: Substantive Due Process in North Carolina,* 52 N.C.L. REV. 763 (1974).

62. *See* text accompanying note 30 *supra.*

63. *See, e.g.,* Note, *The Impending Demise of Resale Price Maintenance,* 1970 WASH. U.L.Q. 68 (1970).

64. *See* text accompanying notes 23-30 *supra.*

death knell of resale price maintenance in the State, for the nonsigner clause is the key to effective fair trade enforcement. But at what cost has this been achieved? Between the North Carolina Supreme Court and the ultimate result the court wished to achieve stood two formidable legal obstacles—the twin pillars of statutory and caselaw precedent to the contrary. The ease with which the court brushed them both aside manifests an exercise of sheer judicial power and will surely provoke a search for the source of such awesome strength. The court made no attempt to reconcile *Bulova Watch* with *Ely Lilly*. While there are differences in the factual backgrounds of the two cases, none are of constitutional significance with respect to the nonsigner clause. *Ely Lilly* is, in a word, overruled. The decision must be understood as a reassertion by the court of its sensitivity to important changes in public policy and its determination and competence to make the law reflect those changes.

MICHAEL A. ALMOND

Public Utilities—Fair Rates for Fair Service

On November 5, 1971, General Telephone of the Southeast (General)[1] applied to the North Carolina Utilities Commission (Commission) for an increase in the rates General charged its North Carolina customers for local telephone service.[2] The Commission found "the record to be replete with evidence of operational inefficiences and chronically poor service"[3] and denied the rate increase.[4] General appealed the order to the North Carolina Court of Appeals which remanded the proceeding to the Commission for specific findings of fact.[5] General then petitioned the North Carolina Supreme Court for certiorari,[6] contending that both the statutory formula for determining the

1. General, a Virginia corporation, serves the Durham, Creedmoor, Altan, Goose Creek and Monroe, North Carolina exchanges. State *ex rel.* Utilities Comm'n v. General Tel. Co., 285 N.C. 671, 674, 208 S.E.2d 681, 683 (1974).

2. State *ex rel.* Utilities Comm'n v. General Tel. Co., 21 N.C. App. 408, 204 S.E.2d 529 (1974).

3. N.C. Utilities Comm'n, Order Denying Rate Increases, Docket P-19 Subs 133 & 136, at 55 (Oct. 23, 1973).

4. *Id.*

5. 21 N.C. App. at 411, 204 S.E.2d at 531.

6. 285 N.C. 596 (1974). Thus, the Commission never made the additional findings.

rates charged by public utilities in North Carolina[7] and the United States Constitution forbade consideration of the quality of service rendered by the utility as a factor in determining the return on investment allowed the company.[8]

The North Carolina Supreme Court in *State ex rel. Utilities Commission v. General Telephone*[9] firmly rejected the statutory argument[10] and apparently rejected the constitutional one.[11] In so doing, the court reaffirmed the principle that the Commission has both a right and a duty to consider the quality of service rendered by a public utility in setting utility rates,[12] but also implicitly brought into doubt the rate-setting formula that has been used in North Carolina since 1899.

North Carolina's statutory scheme for utility rate setting is patterned after the landmark decision of *Smyth v. Ames*[13] in which the United States Supreme Court established the minimum due process requirements for state regulation of utility rates.[14] According to *Ames*, a state's utility commission must first determine the "fair value of the property being used by . . . [the utility] for the convenience of the public."[15] After determining a percentage "fair return" on this "rate base,"[16] the commission must calculate a rate schedule that will allow the company to realize revenues sufficient to earn a "fair return on fair value."[17] *Ames* gave little guidance to state utility commissions on the difficult question of what factors should be considered in computing the

7. N.C. GEN. STAT. § 62-133(b) (1965). *See* State *ex rel.* Utilities Comm'n v. State, 239 N.C. 333, 80 S.E.2d 133 (1954); text accompanying notes 13-17 *infra*.

8. Brief for Appellant at 60, 67, State *ex rel.* Utilities Comm'n v. General Tel. Co., 21 N.C. App. 408, 204 S.E.2d 529 (1974).

9. 285 N.C. 671, 208 S.E.2d 681 (1974).

10. *Id.* at 683, 208 S.E.2d at 688.

11. *Id.* at 682, 208 S.E.2d at 688.

12. This principle was first established in State *ex rel.* Utilities Comm'n v. Morgan, 277 N.C. 255, 177 S.E.2d 405 (1970). (Commonly referred to as *Lee Telephone*).

13. 169 U.S. 466 (1898); *see* Note, *Public Utility Regulation—Time for Reevaluation*, 51 N.C.L. REV. 1140, 1141 (1973).

14. 169 U.S. at 546-47. The specific formula adopted in *Ames* was abandoned by the United States Supreme Court. FPC v. Hope Natural Gas. Co., 320 U.S. 591 (1942). The Court continued to hold that a private utility must be allowed to earn enough to meet its operational and capital expenses. *Id.* at 603.

15. 169 U.S. at 546-47. This valuation is known as the "fair value rate base." Disputes over the proper method for determining the base are probably the most common form of utility regulation litigation. 1 A. KAHN, THE ECONOMICS OF REGULATION 36 (1970). *Ames* and subsequent cases never decided exactly what factors should be used and what weight should be given them in reaching this determination. 169 U.S. at 546-47; 1 A. KAHN, *supra*, at 37-38. *See also, e.g.*, State *ex rel.* Utilities Comm'n v. General Tel. Co., 281 N.C. 318, 338-39, 189 S.E.2d 705, 720 (1972).

16. 169 U.S. at 546-47.

17. *Id.*

rate base or in establishing a "fair return."[18] In relation to the latter point, the Supreme Court in *Bluefield Water Works & Improvement Co. v. Public Service Commission*[19] concluded that every utility is entitled to rates that will yield it a return comparable to other businesses of similar (low) risk.[20]

The test that emerges from *Ames* and *Bluefield* apparently is an economic one. A utility commission first must determine the "fair value" of the company's investment based on its original cost less depreciation, the plant's present replacement cost and the like. The Commission then must survey other governmentally protected industries and determine a "fair rate of return" on this investment base. In this context, "fair" acquires a specialized meaning based more on economic and accounting concepts than equity.

Previously, the North Carolina Supreme Court had held that the rate-setting plan of section 62-133(b) of the North Carolina General Statutes was identical to the *Bluefield* test.[21] That section provides:

> In fixing such rates, the Commission shall:
>
> (1) Ascertain the fair value of the public utility's property . . . .
>
> (2) Estimate such public utility's revenue under the present and proposed rates.
>
> (3) Ascertain such public utility's reasonable operating expenses . . . .
>
> (4) Fix such rate of return on the fair value of the property as will enable the public utility by sound management to produce a fair profit for its stockholders . . . .
>
> (5) Fix such rates to be charged by the public utility as will earn in addition to reasonable operating expenses ascertained pursuant to paragraph (3) of this subsection the rate of return fixed pur-

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18. "In order to ascertain that value [the rate base], the original cost of construction, the amount expended in permanent improvements, the amount and market value of its bonds and stock, the present as compared with the original cost of construction . . . are all matters for consideration." *Id.* This list was neither exhaustive nor mandatory. *Id.* The rate of return must be sufficient for the utility to maintain its plant and pay some dividend to the stockholders. *Id.*

19. 262 U.S. 679 (1923).

20. *Id.* at 690. FPC v. Hope Natural Gas Co., 320 U.S. 591 (1942) expressed the test somewhat differently. The Court held that the rate of return allowed a public utility should be sufficient to pay the operating expenses and the costs of attracting and holding capital. *Id.* at 602. The North Carolina Supreme Court has identified this "cost of capital" test with the *Bluefield* test. State *ex rel.* Utilities Comm'n v. General Tel. Co., 285 N.C. 671, 681, 208 S.E.2d 681, 688 (1974); State *ex rel.* Utilities Comm'n v. Duke Power Co., 285 N.C. 377, 393, 206 S.E.2d 269 (1974); State *ex rel.* Utilities Comm'n v. Morgan, 278 N.C. 235, 179 S.E.2d 419 (1971).

21. State *ex rel.* Utilities Comm'n v. Morgan, 278 N.C. 235, 179 S.E.2d 419 (1971).

> suant to paragraph (4) on the fair value of the public utility's property ascertained pursuant to paragraph (1).[22]

Section 133(b), however, is not the only section in chapter 62 relating to rates.[23] Section 2 declares that the policy of the chapter is to "provide fair regulation of public utilities in the interest of the public, . . . to promote adequate, economical and efficient utility services . . . ." Section 42 empowers the Commission to issue orders to correct deficiences in service. Section 131(b) states that "[e]very public utility shall furnish adequate . . . service." Section 133(a) commands the Commission to set rates that will be fair both to the utility and to consumers, and section 133(d) requires the Commission to consider "all other material facts" in reaching its conclusions as to reasonable rates.

In the light of the above provisions, the court has held that section 133(b) could not be interpreted to "require the Commission to shut its eyes to 'poor' and 'substandard' service . . . ."[24] Instead, in *State ex. rel. Utilities Commission v. Morgan* (commonly referred to as *Lee Telephone*)[25] and again in *General Telephone*, the court held that chapter 62 required the Commission to consider the quality of service rendered by the utility in setting rate levels.[26] "The clear purpose of chapter 62 . . . is to confer upon the Utilities Commission the power and the duty to compel a public utility company to render adequate service and to fix therefore reasonable rates."[27] An implicit *quid pro* exists in all monopoly regulations:[28] "Having been granted a monopoly in its franchise area, the utility is under a duty to render reasonably adequate service."[29]

Although *General Telephone* declared that the "primary purpose

22. N.C. GEN. STAT. § 62-133(b) (1965).

23. "The entire chapter is a single integrated plan. Its several provisions must be construed together so as to accomplish its primary purpose." 285 N.C. at 680, 208 S.E.2d at 687. State *ex rel.* Utilities Comm'n v. Morgan, 277 N.C. 255, 264, 177 S.E.2d 405, 411 (1970).

24. 285 N.C. at 682, 208 S.E.2d at 688, *citing* State *ex rel.* Utilities Comm'n v. Morgan, 277 N.C. 255, 266, 177 S.E.2d 405, 412 (1970).

25. 277 N.C. 255, 177 S.E.2d 405 (1970).

26. 285 N.C. at 683, 208 S.E.2d at 688; 277 N.C. at 266, 177 S.E.2d at 412. In both cases, the court analyzed chapter 62 and used virtually identical language to explain its interpretation. Curiously, *General Telephone* did not cite *Lee Telephone* for this part of its analysis.

27. 277 N.C. at 266, 177 S.E.2d at 412.

28. "A quasi-public entity receives well defined and valuable privileges not accorded a private, unregulated corporation . . . . In return, the State reserves the right to supervise and regulate its operations." State *ex rel.* Utilities Comm'n v. State, 239 N.C. 333, 343, 80 S.E.2d 133, 140 (1954).

29. 277 N.C. at 263, 177 S.E.2d at 410.

of chapter 62 is to assure the public adequate service at reasonable charge,"[30] the court did not decide what method the Commission should use to set rates in compliance with this purpose. Apparently, the court believed that the legislature had given that task to the Commission,[31] whose finding that General rendered "chronically poor service,"[32] like any other finding of fact, was conclusive since it was supported by competent evidence.[33]

Although the Commission specifically noted the *effect* of poor service in assessing General's rate of return,[34] it did not disclose the *method* by which this effect was discovered. Before *General Telephone*, the Commission had determined rates by the economic method of "fair return on fair value." Now, the Commission has evidently modified or discarded that mode of calculation in favor of a nebulous decision about the "real" value of the service.[35] The latter method appears to ignore the *Bluefield* procedure outlined in section 133(b). The statutory method seems objective and precise while the new process is subjective and vague. Nevertheless, the two approaches to ratemaking are reconcilable. Although fair return—the first step of the statutory fair-return-on-fair-value calculation—is perhaps susceptible of objective determination,[36] the fair value of the rate base is not. The Commission "must arrive at its own independent conclusion [about the fair value rate base] without reference to any specific formula . . . ."[37]

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30. 285 N.C. at 680, 208 S.E.2d at 686-87. Previous cases have held that the Commission has the sole authority to determine the adequacy of the utility's service and the rates to be charged therefor. State *ex rel.* Utilities Comm'n v. General Tel. Co., 281 N.C. 318, 336, 189 S.E.2d 705, 717 (1972) and cases cited therein.

31. *See* N.C. GEN. STAT. § 62-130(a) (1965).

32. 285 N.C. at 680, 208 S.E.2d at 686.

33. State *ex rel.* Utilities Comm'n v. Carolina Coach Co., 269 N.C. 717, 722, 153 S.E.2d 461, 465 (1967) and cases cited therein.

34. "We conclude that if all prerequisites were present, a substantially higher rate of return should and would be allowed but that in view of the inefficient and inadequate service . . . no increase in rates should be allowed." N.C. Utilities Comm'n, Order Denying Rate Increases, Docket P-19 Subs 133 & 136, at 56 (Oct. 23, 1973).

35. *See* 285 N.C. at 688, 208 S.E.2d at 692. For a discussion of the inherent impossibility of making objective decisions on the "real" value of utility service, see J. BONBRIGHT, PRINCIPLES OF PUBLIC UTILITY RATES 82-92 (1961).

36. "The apparent precision with which experts . . . compute the fair rate of return is somewhat illusory." State *ex rel.* Utilities Comm'n v. General Tel. Co., 281 N.C. 318, 370, 189 S.E.2d 705, 738 (1972). In addition, the court's efforts at precision have also been illusory. "What constitutes a 'just and reasonable' rate which will return a fair return on the investment depends on . . . 4) what rate constitutes a just and reasonable rate of return on the Rate Base." State *ex rel.* Utilities Comm'n v. State, 239 N.C. 333, 344, 80 S.E.2d 133, 140-41 (1954).

37. State *ex rel.* Utilities Comm'n v. State, 239 N.C. 333, 344, 80 S.E.2d 133, 141 (1954). *See* State *ex rel.* Utilities Comm'n v. General Tel. Co., 281 N.C. 318, 338-39, 189 S.E.2d 705, 718-19 (1972).

Thus, at its core, the process by which the Commission traditionally had calculated rates was subjective.[38] Accordingly, modifying it to include the dictates of the new qualitative approach should be relatively easy. A subjectively determined penalty for poor service is subtracted from a subjectively determined "fair return on fair value."[39] The resulting rate schedule is not only fair according to section 133(b)[40] but also reflects the "real" value of the service.

General argued that the real value method sanctioned an unconstitutional confiscation.[41] While conceding that deficiencies in service should result in a lower valuation of its rate base,[42] General argued that the rate of return could not fall below a percentage return determined by following a literal application of section 133(b).[43] General also claimed that a reduction in the rate of return for inadequate service after a reduction in the rate base constituted a double penalty for the same fault.[44]

In response, the North Carolina Supreme Court stated that the *Bluefield* test "assumes reasonably good service."[45] If the service is adequate, the test is an economic one of "fair return on fair value." If the service is poor, the words remain the same but their meanings

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38. *See* 1 A. KAHN, *supra* note 15, at 37-38. If both the rate base and the rate of return are arrived at arbitrarily, the Commission may easily abandon the entire system while maintaining the appearance of conformity. The Commission would first decide on the revenues to be allowed the utility and then set the rate base and the rate of return accordingly.

39. That is the theoretical approach. A more practical method is simply to deny any increase in rates as a penalty for poor service, adjust the rate base and declare the resulting rate of return to be "just and reasonable" under the circumstances. The North Carolina Supreme Court seems to have endorsed the first method while the Commission seems to have adopted the second. N.C. Utilities Comm'n, Order Denying Rate Increases, Docket P-19 Subs 133 & 136 (Oct. 23, 1973).

40. *See* 285 N.C. at 684-85, 208 S.E.2d at 689-90.

41. Brief for Appellant at 55, 62, State *ex rel.* Utilities Comm'n v. General Tel. Co., 21 N.C. App. 408, 204 S.E.2d 529 (1974).

42. *Id.* at 62.

43. General argued that numerous decisions by both the North Carolina and the United States Supreme Courts had established the principle that a public utility must be allowed to earn a reasonable rate of return. Since the North Carolina Supreme Court held that the rate of return established by N.C. GEN. STAT. § 62-133(b) (1965) was the minimum reasonable rate of return in State *ex rel.* Utilities Comm'n v. Duke Power Co., 285 N.C. 377, 388, 206 S.E.2d 269, 276 (1974), General argued that a lower rate would be per se unreasonable, unconstitutional and confiscatory. Brief for Appellant at 62-67.

44. Brief for Appellant at 55. The court quickly disposed of this argument. The deduction from fair value was for deficiencies in the physical plant. The deduction from fair return was for a different inadequacy—poor management. 285 N.C. at 683-84, 208 S.E.2d at 689.

45. 285 N.C. at 681-82, 208 S.E.2d at 688.

change. In the latter circumstances, "fair" means equitable to the consumer.[46] Consequently, no particular rate of return can be per se unreasonable.[47] While the costs remain the same, the allowable rate of return will vary with the fluctuations in the quality of service.[48]

Since General realized a profit and paid a dividend under the poor service rate, the court found that the allowed rate of return was not confiscatory in fact.[49] The court did not make clear whether the test for a confiscatory rate was profitability or the declaration of dividends. It emphasized the latter criterion,[50] but the declaration of dividends is a poor gage of a company's financial position. A company may pay dividends at the discretion of its board of directors so long as it retains earned surplus.[51] Accordingly, a company could declare dividends during a year in which it had suffered a net operating loss. Conversely, the company could refuse to declare a dividend even though it made a considerable profit on the year.

Rates low enough to force the company to operate at a net loss are probably illegal under section 62. Although the primary purpose of chapter 62 is to assure the public of adequate service at a reasonable charge, as a necessary corollary to this purpose, some protection of investment must be guaranteed to the owners of the public utility's capital.[52] A profitable rate is guaranteed to provide and maintain the facilities necessary for rendering adequate service.[53] Since a utility with poor service probably cannot improve that service while operating at a net loss,[54] any rate that would deny the company a profit because of poor service would be self-defeating.

General Telephone was undoubtedly correct in holding that chapter 62 required the consideration of the quality of service in the public

46. *See id.* at 680-81, 208 S.E.2d at 687.

47. *Id.* at 682, 208 S.E.2d at 688, *citing* Covington & Lexington Turnpike Co. v. Sandford, 164 U.S. 578, 596-97 (1896).

48. "There is no such thing as a reasonable rate for service that is deficient." C. PHILLIPS, THE ECONOMICS OF REGULATION 400 (rev. ed. 1969).

49. "After paying all interest on General's indebtedness, taxes and the dividends on the portion of its preferred stock allocable to North Carolina intrastate service, this left $1,740,282 for the common stockholders. This was sufficient to pay a 6% dividend on . . . the common stock . . . . This is not confiscation." 285 N.C. at 683, 208 S.E.2d at 286.

50. *Id.* at 683, 208 S.E.2d at 689.

51. R. ROBINSON, NORTH CAROLINA CORPORATION LAW AND PRACTICE, § 21-2 to -5 (1974).

52. 285 N.C. at 680, 208 S.E.2d at 687.

53. *Id.*

54. *But see id.* at 685, 208 S.E.2d at 690.

utility rate-making process. The intent of the statute is to allow the utilities to charge equitable rates,[55] and the court has properly restored that commonplace meaning to the once technical phrase "fair return on fair value." Rate setting is a complicated task and requires clearer standards than an individual Commissioner's sense of justice. Since chapter 62 does not provide any guidelines for the incorporation of service quality in the rate-making process, the court should formulate workable standards within the spirit of the statute.

Drawing an analogy from *Bluefield*,[56] the court could require the Commission to survey the quality of service given by other utilities and establish minimal standards of service. The Commission could then lower or even raise rates by the proportion that a given utility's service varied from this standard. While somewhat subjective, this express method would provide a benchmark for review that would be preferable to the unstated procedure apparently adopted by the Commission and approved by the court.

E. THOMAS WATSON

Real Property—Implied Warranty of Workmanlike Quality in New Housing Sales: New Protection for the North Carolina Homebuyer

For the majority of American jurisdictions, application of the doctrine of *caveat emptor* in new housing sales is a long established tradition.[1] These courts frequently justify use of the doctrine by citing the need for certainty of title in real estate actions and the available alternative of express warranties.[2] In *Hartley v. Ballou*,[3] a case of first impression in North Carolina, the supreme court rejected this outmoded tradition in favor of finding an implied warranty of workmanlike quality in new housing sales and thus joined the expanding

55. *See* text accompanying notes 24-27 *supra*.
56. 262 U.S. at 690.

1. *See, e.g.*, Voight v. Ott, 86 Ariz. 128, 341 P.2d 923 (1959); Tudor v. Heugel, 132 Ind. App. 579, 178 N.E.2d 442 (1961); Allen v. Wilkinson, 250 Md. 395, 243 A.2d 515 (1968); Mitchem v. Johnson, 7 Ohio St. 2d 66, 218 N.E.2d 594 (1966).
2. Hartley v. Ballou, 20 N.C. App. 493, 496-97, 201 S.E.2d 712, 714 (1974).
3. 286 N.C. 51, 209 S.E.2d 776 (1974).

minority of jurisdictions[4] that have recognized the necessity of providing some protection to homebuyers.

In October 1969 builder-vendor Ballou completed the dwelling that became the subject of this litigation. Later in that month, and prior to purchase, plaintiff Hartley inspected the house and found it satisfactory with no sign of leakage. At about the time that Hartley moved into the house in December, the basement flooded after a hard rain. In January defendant Ballou spent 4,000 dollars waterproofing the basement, which remained dry for eighteen months until August 1971 when it flooded during a hurricane. The basement flooded one month later during another hurricane and again in October during a heavy rain. Hartley then sued, alleging a breach of both an express and an implied warranty. The trial court found a breach of an implied warranty and granted damages for all incidents of flooding.[5]

After approval by the court of appeals,[6] the North Carolina Supreme Court reversed on grounds that the lower courts misapplied the implied warranty and remanded for a trial *de novo*[7] because of confusion created by variances between the plaintiff's allegations and his proof. Nevertheless, the court explicitly stated that in every sale by a builder-vendor of a new dwelling there is an implied warranty to the initial vendee that, at the time of the passing of the deed or the taking of possession, the dwelling meets the prevailing standard of workmanlike quality.[8]

As noted above, this finding of an implied warranty departs abruptly from the doctrine of *caveat emptor* that controls in most jurisdictions. Although of uncertain origins, the doctrine has been cited by courts and commentators often enough and long enough that it is frequently labeled as an ancient maxim.[9] *Caveat emptor* translates loosely as "buyer beware." Practically speaking it means that the buyer "pays his money and takes his chances."[10] The harshness

4. *See, e.g.*, Carpenter v. Donohoe, 154 Colo. 78, 388 P.2d 399 (1964); Bethlahmy v. Bechtel, 91 Idaho 55, 415 P.2d 698 (1966); Weck v. A:M Sunrise Constr. Co., 36 Ill. App. 2d 383, 184 N.E.2d 728 (1962); Waggoner v. Midwestern Dev., Inc., 83 S.D. 57, 154 N.W.2d 803 (1967); Humber v. Morton, 426 S.W.2d 554 (Tex. 1968).

5. 286 N.C. at 57-58, 209 S.E.2d at 780.

6. 20 N.C. App. 493, 201 S.E.2d 712 (1974).

7. 286 N.C. at 66, 209 S.E.2d at 785.

8. *Id.* at 62, 209 S.E.2d at 783.

9. For an excellent discussion of the origins and development of *caveat emptor* see Hamilton, *The Ancient Maxim Caveat Emptor*, 40 YALE L.J. 1133 (1931).

10. The law of implied warranty has developed far more extensively in personalty than in realty. Caldwell v. Smith, 20 N.C. 193 (1838), an early case involving personal

of this rule in regard to new housing sales has led many courts to adopt one of two alternatives.[11] The first alternative was set out in *Miller v. Cannon Hill Estates Ltd.*,[12] an English case. In this decision, which marked the first rejection of *caveat emptor*, the court held that a house purchased during construction was impliedly warranted to be completed in a workmanlike manner. Thus, the English court drew a distinction over whether the house was purchased before or after construction. Following the lead of *Vanderschrier v. Aaron*,[13] an Ohio case, American jurisdictions initially accepted this dichotomy. Many courts, however, have not found a rational basis for such a distinction. Adopting a second alternative to *caveat emptor*, those dissenting jurisdictions found an implied warranty regardless of whether the house was sold before, during, or after construction.[14]

In *Hartley v. Ballou* the North Carolina court accepted this second alternative, expressly rejecting both *caveat emptor*[15] and the *Miller*[16] approach. The implied warranty however, is not open-ended. The North Carolina court carefully circumscribed the situations and manner in which it may be applied. First, the sale must be made by a builder-vendor.[17] On its face this requirement would seem to permit circumvention of the implied warranty by simply separating the two functions. Courts, however, have usually looked at the realities of a transaction and have found implied warranties in situations in

property, held that *caveat emptor* applied where "the purchaser received the very article for which he contracted—there was no stipulation with respect to its qualities, and these were at least as well known to him as to the vendor." *Id.* at 196. In the area of personalty however, *caveat emptor* gradually gave way to an implied warranty of fitness for use that became codified in the Uniform Commercial Code.

11. Note, *Phasing Out Caveat Emptor: Implied Warranties in Builder-Vendor Contracts*, 2 CAPITOL L. REV. 199 (1973).

12. [1931] 2 K.B. 113.

13. 103 Ohio App. 340, 140 N.E.2d 819 (1957).

14. Of particular interest in studying this transition are two decisions by the Colorado Supreme Court. In Slisar v. Smolenske, 153 Colo. 274, 387 P.2d 260 (1963), the court applied the English rule. Only one year later in Carpenter v. Donohoe, 154 Colo. 78, 388 P.2d 399 (1964), it extended this holding to cover situations in which the house was purchased after completion. The court reasoned "that a different rule should apply to the purchaser of a house which is near completion than would apply to one who purchases a new house seems incongruous . . . . [I]t is recognizing a distinction without a reasonable basis for it." *Id.* at 83, 388 P.2d at 402. For a discussion of this distinction see Beauman, *Caveat Emptor in Sales of Realty—Recent Assaults upon the Rule*, 14 VAND. L. REV. 541, 543-47 (1960).

15. 286 N.C. at 60-62, 209 S.E.2d at 782-83.

16. *Id.* at 61, 209 S.E.2d at 782.

17. The North Carolina court describes this as "the vendor, if he be in the business of building such dwellings." *Id.* at 62, 209 S.E.2d at 783.

which the builder used a realtor to make the sale[18] and in which the vendor used independent contractors for the actual construction.[19] In the latter instance the Texas court noted that it is "highly irrational to make a distinction between the liability of a vendor-builder who employs servants and one who uses independent contractors."[20] The "builder-vendor" requirement primarily serves to emphasize that no implied warranty will run from a purchaser who, obtaining the dwelling in an arms length transaction, subsequently resells in good faith and not for the purpose of evasion.[21]

Another restriction set out in *Hartley* limits the warranty to the "'initial vendee."[22] Thus, the warranty runs to the purchaser and not with the land. This distinction seems to serve no justifiable purpose and is capable of causing considerable problems. Many structural defects are not apparent until the dwelling reaches a certain age or perhaps passes through a particular weather cycle. In *Hartley* for example, had Hartley lived in the house during a dry season and had he been forced to sell the house soon after he acquired it, the purchaser would have had no recourse when the heavy seasonal rains finally exposed the defect. Such a result is highly inequitable. The personal nature of the warranty may be explained as a holdover from considerations of privity,[23] but that is an explanation and not a justification. Although no other jurisdiction has passed on the rights of a repurchaser under a theory of implied warranty,[24] courts have

18. *E.g.*, Bethlahmy v. Bechtel, 91 Idaho 55, 415 P.2d 698 (1966).

19. *E.g.*, Humber v. Morton, 426 S.W.2d 554 (Tex. 1968).

20. *Id.* at 561. The potential for extending liability is vividly demonstrated in Connor v. Conejo Valley Dev. Co., — Cal. App. 2d —, —, 61 Cal. Rptr. 333, 334 (2d Dist. Ct. App. 1967), *vacated*, 69 Cal. 2d 850, 447 P.2d 609, 73 Cal. Rptr. 369 (1968), a case decided on tort liability theory, where the court held a contractor "responsible, for his own work or that of a subcontractor, to the purchasers, subsequent purchasers, or third parties for personal injuries or property damage resulting from substantial defects in construction." Nor did the court stop there. It also extended liability to the lender who apparently did not use good judgment in selecting his developers. This extension was based on public policy and the ability to bear the financial burden.

21. In such a situation the vendor has no greater knowledge than the vendee. Waggoner v. Midwestern Dev., Inc., 83 S.D. 57, 154 N.W.2d 803 (1967).

22. 286 N.C. at 62, 209 S.E.2d at 783; *see* Note, *Sale of House by Builder-Vendor Creates an Implied Warranty of Fitness and Habitability*, 24 ALA. L. REV. 332, 338 n.28 (1972).

23. Most courts facing this issue have followed the logic of MacPherson v. Buick Motor Co., 217 N.Y. 382, 111 N.E. 1050 (1916), a products liability case, in finding privity not a bar. *See, e.g.*, Leigh v. Wadsworth, 361 P.2d 849 (Okla. 1961).

24. In Gable v. Silver, 258 So. 2d 11 (Fla. Dist. Ct. App.), *aff'd per curiam*, 264 So. 2d 418 (Fla. 1972), a case finding an implied warranty for sale of a condominium, the court considered such a problem through dicta. "We ponder, but do not decide, what result would occur if more remote purchasers were involved. We recognize that liability

held, under a strict liability theory, that a builder is liable to a third-party plaintiff[25] or repurchaser[26]—reasoning that might by analogy be used to extend liability beyond the initial vendee under an implied warranty theory.

Another requirement of the holding would limit the warranty to those defects in existence at the time of the passing of the deed or the taking of possession by the initial vendee (whichever first occurs).[27] This criteria sets one limit on the builder's liability. A major problem, which the court did not address, however, concerns the time span of that liability. For example, assuming that a defect in a dwelling was in existence at the time of the passing of the deed and that the initial vendee is still in possession, how long will the builder-vendor remain liable, one year, ten years, twenty years? The problem of determining this time limit has troubled many commentators.[28] The proper time should depend on many factors including the type of defect and its seriousness. In some cases one year may be too long while in others eight years will not be long enough.[29] In finding the actual limit therefore it is essential that courts approach the "duration of the warranty" on a case-by-case basis and apply a test of reasonableness.[30]

Hartley sets the qualitative standard for the warranty by requiring construction in a "workmanlike manner."[31] This warranty extends to the dwelling and all of its fixtures.[32] The North Carolina court explained the workmanlike standard in *Moss v. Knitting Mills*[33] holding that the "law exacts ordinary care and skill only."[34] Implicit

must have an end but question the creation of any artificial limits of either time or remoteness to the original purchaser." *Id.* at 18.

25. Schipper v. Levitt & Sons, Inc., 44 N.J. 70, 207 A.2d 314 (1965).

26. Kriegler v. Eichler Homes, Inc., 269 Cal. App. 2d 224, 74 Cal. Rptr. 749 (1st Dist. Ct. App. 1969).

27. 286 N.C. at 26, 209 S.E.2d at 783.

28. Note, 24 ALA. L. REV., *supra* note 20, at 338-39; Note, *Caveat Emptor—Implied Warranty of Habitability*, 12 DUQUESNE L. REV. 109, 115 (1973).

29. Kreigler v. Eichler Homes, Inc., 269 Cal. App. 2d 224, 74 Cal. Rptr. 749 (1st Dist. Ct. App. 1969).

30. The South Dakota court adopted this standard in Waggoner v. Midwestern Dev., Inc., 83 S.D. 57, 68, 154 N.W.2d 803, 809 (1967). The court stated that "[t]he duration of liability is likewise determined by the standard of reasonableness."

31. 286 N.C. at 62, 209 S.E.2d at 783.

32. *Id.* This statement is in line with other jurisdictions that have allowed recovery for defects in various other items. Gable v. Silver, 264 So. 2d 418 (Fla.) (per curiam), *aff'g* 258 So. 2d 11 (Fla. Dist. Ct. App. 1972) (air conditioner); Schipper v. Levitt & Sons, Inc., 44 N.J. 70, 207 A.2d 314 (1965) (boiler).

33. 190 N.C. 644, 130 S.E. 635 (1925).

34. *Id.* at 648, 130 S.E. at 637. As in other jurisdictions, a perfect dwelling is not required. *See* Waggoner v. Midwestern Dev., Inc., 83 S.D. 57, 154 N.W.2d 803 (1967).

in the notion of workmanlike quality is the idea that the dwelling will be warranted only to hold up under reasonable or foreseeable use. The court brought out this point in *Hartley* by its finding that the dwelling was not warranted to withstand extreme weather conditions such as hurricanes but only the more typical "northeasters."[35]

"Workmanlike manner" is not the terminology used by all courts that have rejected *caveat emptor*. Other jurisdictions, with reference to landlord-tenant law, have spoken in terms of fitness for habitation[36] or with reference to the Uniform Commercial Code, have described the warranty in terms of "fitness and merchantability."[37] Of course, some have adopted the phrase "workmanlike construction" [38] that was used in *Hartley*. In spite of the differences in phraseology, the decisions do not reveal any substantive difference that might be attributed to the particular term applied. Nevertheless it is arguable that the North Carolina court, like other courts,[39] will look with particular emphasis to precedents in the area from which it borrowed its standard, whether it be from landlord-tenant law, the UCC, or common law.

The court stated that the implied warranty in the contract of sale survives the passing of the deed or the taking of possession. Thus, the court rejected the argument that the doctrine of merger operates to fuse the contract into the delivery of the deed, constituting a fulfillment of all its terms.[40]

As a final factor in establishing an implied warranty, the court considered whether Hartley had notice of the defect and stated that "[a]n implied warranty cannot be held to extend to defects which are visible or should be visible to a reasonable man upon inspection of the dwelling."[41] The court used language from the Uniform Commercial Code and analogized from warranties applicable to the sale of goods.[42] In *Hartley* plaintiff had no notice of the defects prior to his

35. 286 N.C. at 62-63, 209 S.E.2d at 783.

36. *See, e.g.*, Bethlahmy v. Bechtel, 91 Idaho 55, 415 P.2d 698 (1966).

37. Gable v. Silver, 264 So. 2d 418 (Fla.) (per curiam), *aff'g* 258 So. 2d 11 (Fla. Dist. Ct. App. 1972).

38. Carpenter v. Donohoe, 154 Colo. 78, 388 P.2d 399 (1964).

39. *See* Note, *Implied Warranties in the Sale of Real Estate*, 26 U. MIAMI L. REV. 838, 843 (1972).

40. For a good discussion of why merger should not apply see Week v. A:M Sunrise Constr. Co., 36 Ill. App. 2d 383, 184 N.E.2d 728 (1962). Essentially, the court held that if there are provisions in the contract that delivery of the deed does not fulfill there is no merger. The incorporation of an implied warranty therefore would prohibit merger.

41. 286 N.C. at 61, 209 S.E.2d at 782.

42. N.C. GEN. STAT. § 25-2-316(3)(b) (1965).

purchase, and thus an implied warranty was applicable. The court, however, did not stop with this assertion. Instead, it appeared to hold that the implied warranty is revocable at any time subsequent to the purchase by notice to the purchaser of the existence of a defect. In *Hartley*, therefore, defendant escaped liability for damage that occurred after the first storm and after the defendant attempted to repair the basement, on the theory that H .rtley then had notice of potential problems.

This concept of revocation must be applied flexibly because strict application, as in *Hartley*, creates new problems. *Hartley* effectively refused[43] to extend the warranty to cover repairs made by the builder-vendor in response to complaints by the purchaser, suggesting that Hartley should have filed suit immediately.[44] This ruling is unsound in light of traditional judicial policy. It will tend to encourage litigation and discourage amicable settlement by the purchaser and the builder-vendor as the purchaser would not want to risk losing his warranty. His sole recourse, should he deal with the builder, would be to obtain an express warranty for the repairs. This provides no satisfactory solution because most purchasers would be unaware of the problem and because builder-vendors would not freely give such a warranty. It seems best, therefore, in the situation in which repairs are carried out by the builder-vendor, to extend the implied warranty to cover them.

In setting out the above factors, the court concerned itself with the initial finding of an implied warranty and with the extent of its application. Once a warranty is found, however, there remains a problem of what damages will be appropriate. *Hartley* addressed that question only through dicta[45] because the alleged notice negated any claim for damages subsequent to the attempt to repair by defendant. Nevertheless, the court offered suggestions on the type of dam-

43. Importantly, however, it is not entirely clear that the court mandated such a result. Rather, the refusal to find further damages may be attributable to the concept of "foreseeability," see text accompanying note 35 *supra*, in that hurricanes or unusual weather conditions caused the later damage. The specific finding of the court that "with knowledge of these facts, plaintiff continued in possession until the waterproofing proved insufficient under hurricane conditions," 286 N.C. at 63, 209 S.E.2d at 784, supports such an interpretation. This foreseeability interpretation seems more consistent with the philosophy of the implied warranty than does the harsh application of notice. *See* Waggoner v. Midwestern Dev., Inc., 83 S.D. 57, 154 N.W.2d 803 (1967) in which the court allowed recovery for leakage on three separate occasions.

44. 286 N.C. at 65, 209 S.E.2d at 785.

45. *Id.* at 63, 65, 209 S.E.2d at 783, 785.

age claims it would entertain. It "assumes" that Hartley could have asked for the difference in market value as impliedly warranted and as it actually existed *or* the cost of repair.[46] The court also suggested that recission might have been appropriate.[47]

By accepting the doctrine of an implied warranty of workmanlike quality in new housing sales, North Carolina supplies homebuyers with practical tools to protect themselves. However, some aspects of the court's holding, such as restriction to the initial vendee and the notice requirement, may cause inequitable results if the language of the court is applied strictly in future cases. On balance the rule announced in *Hartley* is well reasoned. One can hope that it is the forerunner of more judicial acceptance of the responsibility for consumer protection in matters of property law.

CRAIG J. TILLERY

Sales—Applicability of the Uniform Commercial Code to the Sale of a Business

The Sales Article of the Uniform Commercial Code[1] purports to govern "transactions in goods."[2] Although the Code does not define "transactions," it does define "goods" as "all things . . . movable . . . ."[3] In conformance with the broad scope of this definition the North Carolina Court of Appeals recently held that a contract for the sale of a business consisting entirely of movable assets constitutes a "transaction in goods" falling within the coverage of the Code.[4]

Miller v. Belk[5] involved a contract for the sale by Peggy S. Miller of her laundry and dry cleaning business, which consisted solely of

46. *Id.* at 63, 209 S.E.2d at 783.
47. *Id.* at 65, 209 S.E.2d at 785.

1. N.C. GEN. STAT. §§ 25-2-101 to -725 (1965).
2. *Id.* § 25-2-102.
3. *Id.* § 25-2-105(1). The entire definition reads as follows:

(1) "Goods" means all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities (article 8) and things in action. "Goods" also includes the unborn young of animals and growing crops and other identified things attached to realty as described in the section on goods to be severed from realty (§ 25-2-107).

4. Miller v. Belk, 23 N.C. App. 1, 207 S.E.2d 792 (1974).
5. 23 N.C. App. 1, 207 S.E.2d 792 (1974).

tangible, movable assets.[6] When the buyer, Joel L. Kirkley, Jr., refused to consummate the agreement, Miller notified him that she intended to seek legal redress, but said nothing about reselling the business. A short time later, without notifying Kirkley, she did resell to a third party for substantially less than the amount called for in the original contract. She then sued Kirkley to recover the difference between the original contract price and the amount she realized upon resale. After a default judgment was vacated by the court of appeals,[7] a nonjury trial was held, and judgment was entered against Kirkley for the amount sought by plaintiff.

In reversing the trial court, the court of appeals applied the Uniform Commercial Code to the contract[8] and held that plaintiff had failed to comply with the requirement of North Carolina General Statutes section 25-2-706(3) that the seller notify the buyer of his intention to resell in order to recover the difference between the contract price and the resale price.[9] Therefore, plaintiff's recovery was limited to the difference between the contract price and " 'the market price at the time and place for tender.' "[10]

Prior to *Miller* the North Carolina courts had not considered whether the Uniform Commercial Code applies to the sale of a business.[11] The Code does not address the question specifically. The court of appeals, therefore, turned to other jurisdictions for assistance. The case that most influenced the court, *Foster v. Colorado Radio Corp.*,[12] involved a seller's suit for breach of a contract for the sale of a radio station, the assets of which consisted of studios, real estate, transmission equipment, the station's license, good will, and office equipment and furnishings.[13] The Tenth Circuit Court of Appeals divided the contract, applying the Code only to the office equipment and furnishings on the ground that they were the only assets that came within the Code's definition of "goods."[14]

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6. No mention of good will was made by the parties. *Id.* at 5, 207 S.E.2d at 794.

7. Miller v. Belk, 18 N.C. App. 70, 196 S.E.2d 44, *cert. denied*, 283 N.C. 665, 197 S.E.2d 874 (1973).

8. 23 N.C. App. 1, 207 S.E.2d 792. The alternative was to apply North Carolina common law. *See* note 35 *infra*.

9. *Id.* at 5, 207 S.E.2d at 795.

10. *Id.* at 6, 207 S.E.2d at 795, *quoting* N.C. GEN. STAT. § 25-2-708(1) (1965).

11. 23 N.C. App. at 4, 207 S.E.2d at 794.

12. 381 F.2d 222 (10th Cir. 1967).

13. *Id.* at 225-26.

14. *Id.* at 226-27. Non-Code law was applied to the nongoods portion. *Id.* It does not appear from the opinion whether the parties had allocated the purchase price

The only other case cited by the North Carolina court was *Melms v. Mitchell*[15] in which the Oregon Supreme Court applied the relevant Code provisions to a contract for sale of a cordwood business. As in *Miller* all of the assets were tangible and within the Code's definition of "goods."[16] Unlike *Miller*, however, the parties had allocated the purchase price among the assets.[17] The Oregon court held that the Code applied to the transaction because no statutory exception is made for the sale of assets, otherwise qualifying as goods, that are part of a going business.[18]

Notwithstanding *Foster* and *Melms*, one case has recently held that in some circumstances the Code does not apply to the sale of a business consisting of goods and nongoods. *Field v. Golden Triangle Broadcasting, Inc.*,[19] a Pennsylvania case involving a contract for the sale of two radio stations, refused to divide the contract between goods and nongoods, partly on the ground that the parties intended that the contract not be divisible.[20] An important factor in the court's determination of this intention was the lack of reference in the contract to specific assets.[21] The court also distinguished *Foster* on the ground that the goods involved in that case represented a significant portion of the contract price, whereas in *Field* the percentage of goods was insignificant.[22]

Apparently, no other court has discussed the application of the Code to the sale of a business.[23] Thus, the scant authority existing prior to *Miller* held that the Code applied to the sale of a business as a going concern, except when the percentage of the purchase price at-

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among the different assets of the business; however, in discussing the value of each part of the contract the court seems to have assumed or known that the price was not allocated. *See id.*

15. 266 Ore. 208, 512 P.2d 1336 (1973).

16. *Id.* at 217, 512 P.2d at 1340.

17. The parties in *Miller* listed the assets of the business, but they did not assign separate values to them. *See* Record at 29-30.

18. The court also held that allocation of the purchase price negated the possibility that the parties intended to treat the business as a unit. 266 Ore. at 217, 512 P.2d at 1340-41.

19. 451 Pa. 422, 305 A.2d 689 (1973).

20. *Id.* at —, 305 A.2d at 696 (alternative holding). The court held that "the nature of the transaction, the intention of the parties as reflected by the writing, and the lack of specific reference to designated assets renders inescapable the conclusion that the letter agreement was one integrated contract." *Id.*

21. *Id.*

22. *Id.* at —, 305 A.2d at 696.

23. A Georgia case, Crooks v. Chapman Co., 124 Ga. App. 718, 185 S.E.2d 787 (1971), held that the Code did not apply to the contract involved, but gave no reason and did not reveal the terms of the contract.

tributable to the assets within the Code's definition of goods was "insignificant." Furthermore, when the business consisted of significant portions of goods and nongoods, the Code was applied only to the goods portion of the contract, with non-Code law being applied to the nongoods portion.

Since the facts in *Miller* strongly favored application of the Code,[24] the law that North Carolina courts will apply to other contracts for the sale of a business remains open to speculation. Three types of contracts have yet to be evaluated by the North Carolina courts: a contract for the sale of a business whose assets are all goods, in which the price is allocated among the assets; a contract for the sale of a business consisting of significant portions of both goods and nongoods; and a contract for the sale of a business consisting of an insignificant percentage of goods.[25]

In the first case, in which all of the assets of the transferred business are goods and the purchase price is allocated among them, the court would probably apply the Code to the transaction. In *Miller* the price was not allocated,[26] but the court held that the transfer was in reality nothing more than a transfer of the individual assets.[27] Presumably, the court would hold likewise when the parties do allocate the price among the assets.[28]

Arguably, allocation should not be a factor when a business consists entirely of goods, because, regardless of the parties' intention, the sale is a "transaction in goods." The Code lends further support to this result by introducing the concept of the "commercial unit," which is defined as "such a unit of goods as by commercial usage is a single whole for purposes of sale and division of which materially impairs its character or value . . . ."[29] A business consisting entirely of goods will generally fit this definition.[30]

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24. *See* text accompanying note 41 *infra.*

25. A fourth possible contract is one for the sale of a business consisting entirely of nongoods. By its terms the Code is inapplicable to such a contract, but the court may wish to apply the Code by analogy. *See* text accompanying notes 37-38 *infra.*

26. *See* note 17 *supra.*

27. 23 N.C. App. at 5, 207 S.E.2d at 794.

28. In fact, the Oregon Supreme Court in *Melms* reached a similar result largely on the ground that the parties allocated the price. 266 Ore. at 217, 512 P.2d at 1340.

29. N.C. GEN. STAT. § 25-2-105(6) (1965). Although Comment 4 to this section indicates that the definition is intended to help with the phrasing of later sections, the concept is, nevertheless, relevant to the present analysis.

30. Although allocation of the purchase price may indicate that the parties did not intend to treat the business as a unit, any inference of such an intention from mere allocation, without more, would not be warranted, *Melms* notwithstanding. The price of

The second type of contract involves the sale of a business consisting of significant portions of both goods and nongoods. *Foster* is authority for dividing the contract into goods and nongoods portions whether or not the price is allocated among the assets.[31] Such a division would result in application of the Code to the goods portion of the contract and the non-Code law of the jurisdiction to the nongoods portion.[32] Arguably, however, such contracts should not be divided. Because application of the Code may yield a different result than other statutory or common law of the jurisdiction, division of the contract may create anomalous results. For example, the Code is more likely than North Carolina common law[33] to recognize the validity of written contracts that do not specify all the terms agreed to by the parties.[34] Therefore, when a business consists of both goods and nongoods, the contract might be held valid with respect to the former and invalid with respect to the latter.

This and other possible inconsistent results[35] can be avoided by applying only one law to a particular contract. Arguably, the existence

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any item or unit is necessarily determined with reference to its components, whether or not the reference is explicit. Furthermore, if the sale is considered a transfer of each individual asset, the Code more obviously applies to the contract under discussion, because every asset of the business is a "good."

31. By dividing the contract when the price was not allocated, the Tenth Circuit implied that it would do so in the presence of allocation.

32. *See* note 31 and accompanying text *supra.*

33. Because North Carolina never adopted the Uniform Sales Act, article 2 of the Uniform Commercial Code must be compared to the North Carolina case law.

34. *See, e.g.,* N.C. GEN. STAT. § 25-2-203 (1965) (requirement of seal); *id.* § 25-2-204(3) (omission of terms in contract); *id.* §§ 25-2-207(1)-(2) (additional terms in acceptance or confirmation of contract); *id.* §§ 25-2-305(1)-(2) (open price term). The North Carolina Comments at the end of each Code section and at the beginning of Article 2 are helpful in determining where the Code differs from other North Carolina law.

35. Other sections of Article 2 that are said by the North Carolina Comments to change or modify North Carolina law are the following: *id.* § 25-2-104(1) (distinction between merchants and nonmerchants); *id.* § 25-2-201 (statute of frauds); *id.* § 25-2-202(a) (parol evidence rule); *id.* § 25-2-205 (revocability of firm offers without consideration); *id.* § 25-2-209(1)-(2) (modification or rescission of contract); *id.* § 25-2-311 (options and cooperation respecting performance); *id.* § 25-2-316(2) (exclusion or modification of implied warranty of merchantability); *id.* § 25-2-318 (requirement of privity for buyer's family, household, and guests with regard to warranty coverage); *id.* § 25-2-401(1) (effect of reservation of title by seller); *id.* § 25-2-403(1) (power of one with voidable title to "transfer a good title to a good faith purchaser for value"); *id.* § 25-2-403(2) (effect of entrusting "possession of goods to merchant who deals in goods of that kind"); *id.* § 25-2-511(1) (tender of payment as condition to seller's duty of delivery); *id.* § 25-2-610 (effect of anticipatory repudiation); *id.* § 25-2-709 (right to action for price after breach); *id.* § 25-2-716 (buyer's right to specific performance or replevin); *id.* § 25-2-717 (requirement of notice before deduction of damages from price by buyer); *id.* § 25-2-721 (remedies for fraud); *id.* § 25-2-722 (right to sue third party for injury to goods); *id.* § 25-2-723 (proof of market price); *id.* § 25-2-725(1) (statute

of assets that do not meet the definition of "goods" precludes application of the Code to the entire contract, so that non-Code law must be applied. The "commercial unit" concept supports nonapplication of the Code because by definition the commercial unit must be a "unit of goods."[36] On the other hand, the Code has been applied by analogy to other transactions involving items not within the Code's definition of goods.[37] Moreover, applying the Code by analogy to the nongoods portion of a business would provide in most cases a more modern rule than non-Code law for resolving the relevant issue.[38]

Finally, when a business consists of both goods and nongoods, but only an "insignificant" amount of goods, *Field* supports application of non-Code law to the entire contract, at least when the price is not allocated among the assets.[39] If, however, the court is willing to apply the Code to the goods portion of the contract except when the percentage of goods is "insignificant," it must determine the meaning of "insignificant." *Field* apparently considered goods comprising less than five percent of the total assets to be insignificant.[40] To avoid such arbi-

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of limitations); *id.* § 25-2-725(2) (time of accrual of cause of action). The list is not exhaustive.

Foster demonstrates the problem. In that case, although plaintiff resold the entire business in one transaction, the court denied recovery only on the goods portion of the contract. 381 F.2d at 226-27. The result in *Miller*, however, would apparently have been the same if the Code had not been applied. *Cf.* Clinton Cotton Mills, Inc. v. Goldberg, 202 N.C. 506, 163 S.E.2d 455 (1932); Lamborn & Co. v. Hollingsworth & Hatch, 195 N.C. 350, 142 S.E. 19 (1928). However, an earlier case, Merrill v. Tew, 183 N.C. 172, 110 S.E. 850 (1922), allowed the seller to recover the difference between the original contract price and the resale price without mention of a notice requirement. It may be that either the seller in fact gave notice or the buyer did not raise the issue, but neither explanation appears in the opinion.

36. UNIFORM COMMERCIAL CODE § 2-105(6). Nevertheless, the Code has been applied to entire contracts that involved more than goods. *See, e.g.*, Bonebrake v. Cox, 499 F.2d 951 (8th Cir. 1974). *Contra*, Gallegos v. Graff, 32 Colo. App. 213, 508 P.2d 798 (1973); Epstein v. Giannattasio, 25 Conn. Supp. 109, 197 A.2d 342 (C.P. 1963). The cases can be reconciled on the basis of the main purpose of the transactions involved in each case. *Bonebrake* involved a contract for the sale of goods, with services provided incidentally, whereas in *Epstein* and *Gallegos* the goods were provided only incidentally. The cases are not directly analogous to the question above since, by assumption, neither the goods nor the nongoods are merely incidental, but they do indicate a judicial willingness to apply only one law to a contract.

37. *See* UNIFORM COMMERCIAL CODE § 2-105, Comment 1 (application of Code by analogy to investments securities approved).

38. If the relevant non-Code law is statutory, however, this option is not available, because the court is not free to disregard a statute that is clearly applicable.

39. 451 Pa. at —, 305 A.2d at 696.

40. In *Field* the goods represented approximately four and a half per cent (measured in terms of value or price) of the total assets of the business, *id.* at — & n.9, 305 A.2d at 696 & n.9, whereas in *Foster* the goods accounted for five to ten percent. 381 F.2d at 226 n.5.

trary distinctions, the court should determine the applicable law as if the business consisted of "significant" portions of both goods and non-goods. It must be observed, however, that as the percentage of goods becomes smaller, the justification for applying the Code rather than non-Code law likewise decreases, by the literal terms of the Code.[41]

On its facts *Miller* is a logical application of the cases decided in other states. Even under the "commercial unit" theory the court was correct in applying the Uniform Commercial Code since the business was a "commerical unit" of goods. The court of appeals, however, arguably erred in its apparent endorsement of the *Foster* theory that the Code's drafters intended the Code to apply to any contract for the sale of a business.[42] Such a specific intention does not appear in the Code or its Comments. In fact, by its literal terms the Code should be limited to cases, such as *Miller*, in which the entire business consists of goods.

Notwithstanding the defect in the reasoning in *Foster*, a broader intention on the part of the drafters does support application of the Code to contracts for the sale of other types of businesses. This intention manifests itself in the expressed purpose of the Code to "modernize the law governing commercial transactions."[43] The Code may be applied by analogy to situations outside of its literal coverage when reason and logic so require.[44] Relying on the broader intention of the drafters will often enable the court to avoid the inconsistencies that may result from division of the contract and to gain the advantages provided by application of a more modern rule to the transaction.

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41. Unless the non-Code law is statutory the Code could still be applied by analogy if the court accepts that theory.

42. *See* Miller v. Belk, 23 N.C. App. 1, 4-5, 207 S.E.2d 792, 795 (1974).

43. UNIFORM COMMERCIAL CODE § 1-102(2)(a).

44. *See id.*, Comment 1; *id.* § 2-105, Comment 1.

Securities—Underdevelopment of Securities Fraud in North Carolina Courts and the Potential Effect of the North Carolina Securities Act of 1975

Securities fraud[1] has presented special problems and has traditionally received special treatment, especially under federal law. This special treatment seems to result from recognition of two basic facts: first, there is a great potential for fraud and unfair dealings when corporate insiders[2] and other sophisticated investors deal with private investors; secondly, due to the peculiar nature of securities, detection of fraud in securities transactions is normally very difficult.[3] In recognition of these problems, Congress and the Securities and Exchange Commission enacted securities laws, rules and regulations that seek to impose high standards on all persons who buy and sell securities by prohibiting certain conduct.[4] The resulting federal law developed in the federal courts has carried out this congressional, and public, desire for exacting standards, especially when insiders are involved.[5]

Despite these developments on the federal scene, state courts have traditionally applied common-law concepts of fraud in the securities area, regardless of the parties involved. While several recent cases indicate a trend toward integration of federal securities law concepts into state law,[6] the North Carolina courts very recently showed themselves to be firmly entrenched in the common-law view of securities fraud.

In *Ragsdale v. Kennedy*[7] the president and general manager of a corporation, in connection with the sale by him of some of the com-

1. "Securities fraud" is fraud committed in the registration, purchase or sale of securities. This note is concerned only with fraud in the purchase or sale of securities.

2. Corporate "insiders" will be used in this note as referring to officers and directors of the corporation.

3. This difficulty results from the actualities of securities transactions. For example, a purchaser, perhaps in reliance upon representations made to him, decides to purchase some stock in a corporation. He receives a piece of paper. The most careful inspection of this piece of paper will not disclose whether the representations of the seller were accurate or fraudulent. With the exception of some latent defects, this situation does not apply to purchases of houses, cars, or almost any other commodity.

4. *See, e.g.*, Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-hh (1970); S.E.C. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1974).

5. Such federal law is based mainly upon rule 10b-5 that makes it unlawful to commit any act of deception in the purchase or sale of securities. The basic requirement of rule 10b-5 is complete disclosure. *See* text accompanying notes 25-31 *infra*.

6. *See* text accompanying notes 18-22 *infra*. *See also* N. LATTIN, THE LAW OF CORPORATIONS 296 (2d ed. 1971); R. ROBINSON, NORTH CAROLINA CORPORATION LAW AND PRACTICE § 12-14, at 252-54 (2d ed. 1974).

7. 286 N.C. 130, 209 S.E.2d 494, *rev'g* 22 N.C. App. 509, 207 S.E.2d 301 (1974).

pany's stock, made misleading statements concerning the condition of the corporation and failed to disclose material facts about the corporation's financial condition. Subsequently, the president-general manager sued on a note given by the purchasers as partial payment for the stock. The purchasers alleged fraud as a defense to the suit. The court of appeals affirmed judgment on the pleadings in favor of the president, finding neither actual fraud nor a fiduciary relationship upon which to base a finding of constructive fraud.[8] The North Carolina Supreme Court, however, reversed and remanded on the ground that there was sufficient evidence of active fraud to present a jury question. The supreme court based its decision on the rule "that even though a vendor may have no duty to speak under the circumstances, nevertheless if he does assume to speak he must make a full and fair disclosure as to the matters he discusses."[9] The court further stated that in North Carolina "when the circumstances make it the duty of the seller to apprise the buyer of defects in the subject matter of the sale known to the seller but not to the buyer, suppression of the defects constitutes fraud."[10] In addition to establishing these principles, the court outlined the essential elements of a cause of action for actionable fraud: "(1) false representation or concealment of a material fact, (2) reasonably calculated to deceive, (3) made with intent to deceive, (4) which does in fact deceive, (5) resulting in damage to the injured party."[11]

The two courts seem to have applied correct concepts of active fraud under North Carolina law.[12] The general rule in North Carolina is that intentional misrepresentation of material facts by a corporate insider in the purchase or sale of the corporation's securities is actionable under common-law principles of fraud,[13] whereas mere

8. 22 N.C. App. 509, 514, 207 S.E.2d 301, 306 (1974).

9. 286 N.C. at 139, 209 S.E.2d at 501.

10. *Id.* at 140, 209 S.E.2d at 501. It should be noted that the purchasers were directors and therefore had a duty to stay informed of the activities and conditions of the corporation. Anthony v. Jeffress, 172 N.C. 378, 379, 90 S.E. 414, 415 (1916); R. ROBINSON, *supra* note 6, § 12-6, at 234-35. However, the fact that the president controlled and managed the corporation, failed to call directors' meetings, and knew that the purchasers were relying on his statements would seem to place a duty upon him to disclose fully and truthfully all material facts relating to the condition of the corporation.

11. 286 N.C. at 138, 209 S.E.2d at 500.

12. *See* Johnson v. Owens, 263 N.C. 754, 140 S.E.2d 311 (1965); Bruton v. Bland, 260 N.C. 429, 132 S.E.2d 910 (1963); Early v. Eley, 243 N.C. 695, 91 S.E.2d 919 (1956); Lester v. McLean, 242 N.C. 390, 87 S.E.2d 886 (1955); Berwer v. Union Cent. Life Ins. Co., 214 N.C. 554, 200 S.E. 1 (1939).

13. *See, e.g.*, Johnson v. Owens, 263 N.C. 754, 140 S.E.2d 311 (1965); R. ROBINSON *supra* note 6, § 12-14, at 252.

non-disclosure of a material fact is actionable only when the insider is found to have breached a fiduciary obligation.[14] The majority view in state courts is that insiders owe fiduciary duties to shareholders only in the conduct of corporate affairs—not in personal dealings with shareholders.[15] The court of appeals in *Ragsdale* clearly showed its adherence to the majority view.

Ragsdale is significant for two reasons. First, it illustrates the requirements of proof in the area of common-law fraud and the difficulties these requirements present to one who must prove such fraud. Requirements of proof of scienter (including knowledge of falsity and intent to deceive), justifiable reliance and causation have proved very difficult for many plaintiffs in securities cases, and non-disclosure has rarely been actionable under state law.[16] The basic weakness in the older and perhaps still majority common-law rule, which the North Carolina courts applied in *Ragsdale*, is that a director or officer can deal with individual shareholders at arms' length without any fear of liability so long as he merely avoids actual, intentional, fraudulent misstatements.

Secondly, *Ragsdale* is significant for the rather remarkable fact that the majority opinions of both courts not only failed to recognize recent developments in federal securities law, but also failed even to acknowledge the existence of the recent trend among state courts toward adopting federal law concepts in the area of securities fraud.[17]

This recent trend among state courts appears to be a reaction to the general weaknesses and the particular difficulties of recovery by injured investors in securities fraud cases when common-law fraud concepts are applied.[18] One of the first decisions to signal a development of state law similar to federal doctrines in the securities area was *Diamond v. Oreamuno*.[19] There the New York Court of Appeals faced the question of whether officers and directors of a corporation are accountable for gains realized by them in transactions in

14. *See, e.g.*, Vail v. Vail, 233 N.C. 109, 63 S.E.2d 202 (1951).

15. H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS 471-72 (2d ed. 1970). *See, e.g.*, Ragsdale v. Kennedy, 22 N.C. App. 509, 515, 207 S.E.2d 301, 305 (1974). The minority view has found a fiduciary duty even in dealings with shareholders. *See, e.g.*, Hotchkiss v. Fischer, 136 Kan. 530, 16 P.2d 531 (1932). The intermediate view, however, has found no such duty absent "special facts." *See, e.g.*, Strong v. Repide, 213 U.S. 419, 431 (1909).

16. A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10B-5 § 2.7, at 55 (1969).

17. *See* authorities cited note 6 *supra*.

18. *See* text accompanying note 16 *supra*.

19. 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

the company's stock as a result of their use of material inside information. In answering the question affirmatively, the court held two corporate officers liable to the corporation in a derivative suit for the amount of money they saved by selling their shares of stock with knowledge of adverse inside information before such information was disclosed to the public. The court ruled that the insiders breached their fiduciary duty by using a corporate asset, the inside information, for their own benefit and were thus liable even though no damage to the corporation was shown. The court based its decision upon theories of federal law, acknowledging that the precise question before them had been decided under New York law but recognizing that nothing in the federal law preempted the power of states to create remedies that seek to effectuate purposes similar to those of the federal law.[20]

More recently, *Schein v. Chasen*,[21] relying upon *Diamond*, held that under the law of Florida the president of a publicly held corporation, together with a brokerage firm and two mutual funds by whom the president's tippees and subtippees were employed, could all be held liable to the corporation for their gains resulting from sales of their stock before certain adverse information was publicly disclosed. Admittedly, *Diamond* and *Schein* do not deal with the question of remedies available to injured investors. The cases are very significant to the present discussion, however, because federal-law concepts were used in cases in which state law was being applied.[22]

The doctrines enunciated by the federal courts in interpreting federal securities law are preferable to common-law doctrines in the area of securities fraud because they allow injured investors to recover more readily. This situation results from two principal differences between federal and state law: first, federal law recognizes a cause of action based upon non-disclosure; secondly, federal law has dispensed with the requirement of proof of scienter.[23] Basically, all that is required under federal law is proof of misrepresentation or non-dis-

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20. *Id.* at 503, 248 N.E.2d at 915, 301 N.Y.S.2d at 85.

21. 478 F.2d 817 (2d Cir. 1973), *vacated and remanded sub nom.* Lehman Bros. v. Schein, 416 U.S. 386 (1974) (remanded to the court of appeals to reconsider whether the controlling issue of state law should be certified to the Florida Supreme Court).

22. For a discussion of these cases see R. ROBINSON, *supra* note 6, § 12-14, at 252-53.

23. A. BROMBERG, *supra* note 16, § 8.4, at 203; *see, e.g.*, White v. Abrams, 495 F.2d 724 (9th Cir. 1974).

closure of a material fact and some resulting damage to the plaintiff.[24]

The foundation of most federal law in the securities fraud area is rule 10b-5,[25] promulgated by the SEC under section 10b of the Securities Exchange Act of 1934.[26] The rule makes unlawful any fraud in connection with the purchase or sale of any security accomplished directly or indirectly by the use of the mails or interstate commerce or any facility of any national securities exchange.[27] The type fraud prohibited includes false statements, non-disclosures and any kind of activity that might mislead or deceive, so long as such activity occurs "in connection with the purchase or sale of any security."[28] Furthermore, the fraud must relate to a "material fact," which the United States Supreme Court has defined as any fact that a reasonable investor would consider important in making a decision.[29] In cases involving personal transactions, proof that the untrue statement or non-disclosure, if material, was relied upon and in fact caused the loss may be required,[30] whereas in cases involving dealings with the general public, proof of materiality alone will satisfy the requirements of reliance and causation.[31]

An early case held that a person injured by acts constituting a violation of rule 10b-5 has an implied right of action against the violator for damages even though no such relief is expressly provided in the

24. A. BROMBERG, *supra* note 16, § 8.1, at 194. For a discussion of the requirement of misrepresentation or non-disclosure of a material fact see *id.* §§ 8.1-.3, at 194-202. For a discussion of the requirement of resulting damage to plaintiff, variously described in terms of reliance, causation or privity, see *id.* §§ 8.5-.7, at 205-20.

25. 17 C.F.R. § 240.10b-5 (1974). The full text of the rule is as follows:

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

26. 15 U.S.C. §§ 78a-hh (1970).

27. The requirement that interstate commerce, mails, or a national security exchange be used has been construed loosely by the courts. A. BROMBERG, *supra* note 16, § 11.2, at 245; *see, e.g.*, Myzel v. Fields, 386 F.2d 718, 727-28 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) (holding that an *intrastate* phone call suffices because the telephone system is *interstate*).

28. 17 C.F.R. § 240.10b-5 (1974).

29. Affiliated Ute Citizens v. United States, 406 U.S. 128, 154 (1972).

30. R. ROBINSON, *supra* note 6, § 16.2, at 335.

31. *Id., citing* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972).

Act.[32] This case was the beginning of a line of cases that ultimately led to the establishment of strict standards, duties and liabilities for corporations and corporate insiders in their dealings with the public, the most basic and most pervasive duty being that of full disclosure.[33] These standards and duties resulted from the fact that conduct prohibited by rule 10b-5 and its progeny of case law includes not only the making of untrue statements but also *any* activity that might deceive or mislead, including non-disclosures.[34]

A second reason why federal securities fraud law is preferable to common-law fraud is that the federal concepts come closer to satisfying public desires and interests. The existence of state blue sky laws and federal securities laws reflects the public desire and the necessity for high ethical standards in securities transactions. The potential for fraud and unfair dealings when insiders and sophisticated investors deal with private investors requires legislative and judicial action to create and enforce high standards in general and fiduciary duties in particular upon these insiders. The problems and difficulties of proof under common-law fraud[35] and the resulting barrier to recovery by injured investors create little deterrence of securities fraud and consequently do not accomplish the public desire for high standards in the securities area. Therefore, it is desirable that state courts apply federal-law concepts instead of common law in the securities fraud area.

Regardless of the desirability of, and the apparent recent trend toward, integrating federal law into state securities fraud cases, a threshold question that must be answered is whether it is proper for state courts to exercise jurisdiction in the securities fraud area in the face of section 27 of the 1934 Act[36] that establishes exclusive jurisdiction in the federal district courts of rule 10b-5 and other 1934 Act litigation. The answer is that such state court action seems proper within certain limitations. The legislative purpose in enacting section 27 appears to have been to achieve consistency in the interpreta-

32. Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). For a discussion of the theory behind this implied liability under Rule 10b-5 see A. BROMBERG, *supra* note 16, § 2.4, at 27-34.

33. *See, e.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); SEC v. Texas Gulf Sulfur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

34. R. ROBINSON, *supra* note 6, § 16-2, at 334. Clearly the conduct of the president-general manager in *Ragsdale* constituted prohibited activity under federal securities law.

35. *See* text accompanying note 16 *supra*.

36. 15 U.S.C. § 78aa (1970).

tion of the federal securities law by confining actions to federal courts, instead of depending on the United States Supreme Court to resolve conflicts between state courts. The ultimate purpose of the provision is to prevent the state courts from disrupting the development of this particular federal law.[37] Therefore, so long as state courts decide only state law and do not interpret federal law, there seems to be no conflict.[38] Section 28(a) of the 1934 Act is consistent with this view.[39] It makes clear that Congress did not intend to preempt state regulation of securities fraud, and therefore state blue sky laws and traditional common law are impliedly retained. "Congress established *concurrent* jurisdiction for the regulation of securities transactions, while it vested *exclusive* jurisdiction in the federal courts for the enforcement of the 1934 Act."[40]

Therefore, there appears to be no compelling or justifiable reason why North Carolina courts should not follow the recent trend among state courts and begin to apply the federal-law concepts of securities fraud. On the contrary, there are strong reasons and even statutory support for such action.

As noted previously, the public desire for high standards in the securities area requires legislative and judicial creation and enforcement of high standards in general and fiduciary duties in particular upon corporate insiders. Significantly, the North Carolina Business Corporation Act provides that "[o]fficers and directors shall be deemed to stand in a fiduciary relation to the corporation and to its shareholders. . . ."[41] This provision is unusual, although not unique, in that it explicitly treats the relationship as a fiduciary one and makes the duty run to shareholders as well as to the corporation.[42]

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37. 83 HARV. L. REV. 1421, 1427 (1970).

38. *Id.*

39. 15 U.S.C. § 78bb(a) (1970). Section 28(a) states that the provisions of the Securities Exchange Act of 1934 are "in addition to any and all other rights and remedies that may exist at law or in equity." Arguably, this language encompasses state law at the time of enactment of the federal law and state law extensions into other areas—for example, insider trading. Consequently, if a case has a tenable theoretical basis in state law, the state court should be able to exercise its jurisdiction, regardless of whether on the same facts a 10b-5 action in federal court exists also. 83 HARV. L. REV., *supra* note 37, at 1428.

40. Note, *The Effect of Prior Nonfederal Proceedings on Exclusive Federal Jurisdiction Over Section 10(b) of the Securities Exchange Act of 1934*, 46 N.Y.U.L. REV. 936, 937-38 (1971). The author explores the problems arising when actions are brought in federal court under 10b-5 following a state court verdict on the same facts.

41. N.C. GEN. STAT. § 55-35 (1965).

42. Folk, *Revisiting the North Carolina Corporation Law: The Robinson Treatise Reviewed and the Statute Reconsidered*, 43 N.C.L. REV. 768, 796-97 (1965).

Described as "one of the strongest and best features of the North Carolina statute,"[43] this explicit recognition of a direct fiduciary duty owed by insiders to the corporation and shareholders creates a "firm cornerstone for generally enforcing high ethical standards in many different and varied situations."[44]

This fiduciary duty as codified in the statute "provides a strong rationale for holding that an insider has a positive obligation under [North Carolina] law to disclose to any shareholder from whom he is buying shares, as well as to any prospective shareholder to whom he is selling, material inside information affecting the value of those shares."[45] However, the North Carolina Court of Appeals in *Ragsdale* held that section 55-35 of the North Carolina General Statutes applies only when the insider is acting "in the conduct of the business and in the management of the affairs of a corporation."[46] There appears to be no statutory support for this holding. The statute is silent about whether the fiduciary relationship obtains in corporate dealings or personal dealings, or both. However, due to the well-established duty of loyalty of an insider to his corporation and to its shareholders when acting in corporate affairs,[47] the statute adds little unless it extends the fiduciary duty to personal dealings.

The public desire for high standards in order to deter fraud, the recent trend among other state courts, the preferability of federal securities law, and section 55-35 seem to justify, if not demand, a change in North Carolina law in the securities fraud area. However, North Carolina is part of a majority of state courts that have not yet applied federal law as developed under rule 10b-5 to common-law fraud cases, even when alleged securities fraud by corporate insiders is involved. The likelihood of such application, however, is greater when a state's blue sky law resembles provisions of the federal securities laws.[48]

Effective April 1, 1975, North Carolina enacted a new blue sky

43. *Id.* at 796.

44. *Id.* at 797. The refusal of the North Carolina courts, as exemplified by *Ragsdale*, to recognize this cornerstone and begin building upon it a body of case law requiring full disclosure and accurate representations by corporate insiders in their dealings with private investors, is not conducive to high ethical standards in securities transactions. While federal law is always available to compel high standards, it is desirable that state law and state courts seek to attain the same result.

45. R. ROBINSON, *supra* note 6, § 12-14, at 253.

46. 22 N.C. App. at 515, 207 S.E.2d at 305.

47. R. ROBINSON, *supra* note 6, § 12-5, at 232-33; *see, e.g.*, Anthony v. Jeffress, 172 N.C. 378, 380, 90 S.E. 414, 415 (1916); Townsend v. Williams, 117 N.C. 330, 336, 23 S.E. 461, 463 (1895).

48. *See* A. BROMBERG, *supra* note 16, § 2.7, at 58.

law, known as the North Carolina Securities Act.[49] Modeled after the Uniform Securities Act,[50] probably the most significant difference between it and the prior blue sky law is in the area of fraud. One of the most notable deficiencies of the old blue sky law was that it was absolutely silent on the subject, except in the context of registration. The new law should adequately fill this void. Section 78A-8 of the North Carolina General Statutes prohibits fraudulent practices in connection with the sale or purchase of securities. This section, which is almost identical to SEC rule 10b-5,[51] provides the basis for certain types of administrative proceedings, judicial injunctions[52] and criminal prosecution.[53] Section 78A-56(j) expressly provides, however, that Section 78A-8 is not a basis for civil liability, which is governed by section 78A-56(a) and (b).

Section 78A-56(a)(2) of the Act imposes civil liabilities on any person who "[o]ffers or sells a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading . . . ."[54] This language is essentially that of the second clause of the Act's anti-fraud provision,[55] which, as previously noted, is almost identical to that of Rule 10b-5. Section 78A-56(b) of the Act imposes similar liabilities on the purchaser of a security. Together, these sections mean that, if a buyer or seller of securities makes an untrue or misleading statement of a material fact or fails to disclose a material fact, he is subject to civil liability.

The existence of a statutory section with language almost identi-

49. N.C. GEN. STAT. §§ 78A-1 to -65 (Supp. 1974).

50. The new North Carolina Blue Sky Law is not identical to the Uniform Securities Act (U.S.A.). The differences result partly from the fact that the drafters used the Wisconsin version of the U.S.A. as a model. One significant and desirable difference is that the U.S.A. provides for civil liability of fraudulent sellers only, whereas the Wisconsin and North Carolina versions extend civil liability to fraudulent purchasers as well. N.C. GEN. STAT. § 78A-56(b) (Supp. 1974).

51. *See* note 25 *supra.*

52. Any violation, whether wilful or otherwise, of the Act's anti-fraud provisions is subject to injunctive action. N.C. GEN. STAT. § 78A-47 (Supp. 1974).

53. Any person who wilfully violates the Act's anti-fraud provisions is subject to the criminal penalties of a fine of up to $5,000.00, or imprisonment for up to five years or both. *Id.* § 78A-57.

54. Had the new blue sky law been in effect in North Carolina at the time of the suit in *Ragsdale,* section 78A-56(a)(2) clearly would have provided a remedy for the purchasers since the president's conduct fitted the section's express language. *Id.* § 78A-56(a)(2).

55. *Id.* § 78A-8(2).

cal to that of SEC rule 10b-5 provides strong support for adoption of federal-law principles.[56] Since many securities fraud issues are and will be subject to both federal and state law, it seems desirable that state law be coordinated with federal law to the fullest extent possible.[57]

CONCLUSION

The long-stated aim of the anti-fraud securities laws and rules is to equalize the bargaining power of parties to securities transactions and provide equal access to all material information that could affect the value of the securities being sold.[58] The courts in *Ragsdale* fell short of this aim by refusing even to acknowledge the existence of a possible securities fraud case and by dealing with the case in terms of common-law fraud rather than in terms of the securities fraud law that has been developing in this country for the past fifty years. With the enactment of the new North Carolina Securities Act the courts should break away from common-law fraud concepts when dealing with cases involving alleged fraud in securities transactions. Moreover, they should go beyond strict enforcement and application of the new Securities Act provisions relating to fraud and instead should join the recent trend among state courts and apply federal law standards as developed under SEC rule 10b-5. Until the North Carolina courts adopt such an approach, it is certain that defrauded investors will have a much easier time obtaining relief in federal courts.[59]

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56. As noted previously, civil liability under federal law has been implied by the courts. Under North Carolina law such civil liability is statutory. *Id.* § 78A-56.

57. Even assuming such coordination of state and federal law, it must be noted that suit in federal courts under rule 10b-5 will almost always be more attractive. Despite the fact that the Uniform Securities Act, as enacted in North Carolina, has adopted all three 10b-5 clauses in its general prohibition, *id.* § 78A-8, and clause two in its express civil liability provision, *id.* § 78A-56, there is no assurance of the broad implied liability that has been posited in federal case law. Even if state courts were able to grant implied liability and were as favorable to private investors in other respects, a 10b-5 suit in federal court will still be more attractive in many cases for several reasons, including the following: federal law can cross borders for jurisdiction, venue and process; federal law has a background and framework sympathetic to investors; federal discovery rules are more liberal than those in some states. A. BROMBERG, *supra* note 16, § 2.7, at 57.

58. *See* Speed v. Transamerica Corp., 99 F. Supp. 808, 828-29 (D. Del. 1951); A. BROMBERG, *supra* note 16, § 3.2, at 64.

59. It is interesting to speculate whether an allegedly defrauded investor-defendant, such as in *Ragsdale*, can get into federal court. It is clear that defendants in this case could not have removed the action to the federal courts. C. WRIGHT, HANDBOOK OF THE

Sovereign Immunity—Should the King Remove His Armor?

Amid boisterous calls for governmental responsibility, the ancient doctrine of sovereign immunity acts as a stagnant moat between the injured subject and the sovereign's castle keep. Recently, however, the North Carolina Court of Appeals entered the lists to combat this kingly concept, holding in *Smith v. State*[1] that the State waived its immunity from suit by entering into a legislatively authorized employment contract that it subsequently breached.[2] In so ruling, the court of appeals clearly pierced the sovereign's armor, an act that may lead to a further weakening of the defense.

Section 122-25 of the North Carolina General Statutes[3] gave the North Carolina Commissioner of Mental Health the power to appoint a medical superintendent for each state-owned and state-operated hospital. Under this authorization, plaintiff, Dr. C. Capers Smith, was appointed to a six-year term as superintendent of Broughton Hospital in Morganton, North Carolina. After apparently performing satisfactorily in this position for two years and seven months, plaintiff was summarily dismissed after a dispute with his supervisor. Plaintiff alleged that the dismissal was without cause or authority, was contrary to statute, and was effected without a hearing or due process.

As a result of the dismissal and other alleged injuries, plaintiff sued the State of North Carolina and other co-defendants seeking to recover compensatory damages. A motion by defendants to dismiss the action on the ground of sovereign immunity was denied by the trial court, and the North Carolina Court of Appeals affirmed the ruling.

To evaluate the court's decision properly, it is necessary to understand the concept of sovereign immunity and its application by the courts. Sovereign immunity refers to the common-law rule that an action, whether at law or in equity, cannot be maintained against the State, in any court, by any plaintiff[4] unless the State expressly consents

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LAW OF FEDERAL COURTS § 38, at 131 (2d ed. 1970). It is not clear, however, whether defendants could have brought a separate suit in federal court based upon rule 10b-5. Such was permitted in *Eason v. GMAC*, 490 F.2d 654 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

1. 23 N.C. App. 423, 209 S.E.2d 336 (1974).
2. *Id.* at 426, 209 S.E.2d at 338.
3. This statutory provision was repealed in 1973 as part of the reorganization of state government. Act of May 14, 1973, ch. 276, § 133(c), 1973 N.C. Sess. Laws 576.
4. *See* Orange County v. Heath, 282 N.C. 292, 192 S.E.2d 308 (1972); 7 J.

to suit or otherwise waives its immunity.[5]

The doctrine, which is deeply rooted in the common law, apparently evolved in England as a legal formalization of the monarchistic, religious principle that "the King can do no wrong."[6] It followed that there was no need for suits against the sovereign; and none were allowed. It is uncertain why this monarchical rule was adopted by the newly independent states, fearful as they were of the excesses of government.[7] Nevertheless, all states have at one time given effect to the doctrine, and many still do, giving various justifications for its modern application.[8] Regardless of the recognized basis for the rule, it seemed for many years to be firmly entrenched in the judicially declared law of the several states.

In spite of this weighty precedent, current judicial thought has moved toward the abandonment of sovereign immunity.[9] In fact, at least one state supreme court has totally abrogated the doctrine.[10] In addition, most states have curtailed the operation of sovereign immunity in the area of state tort liability, distinguishing between claims arising out of the performance of "proprietary" and "non-proprietary" governmental functions.[11] On the other hand, in the area of governmental contracts, even though some courts have seen the necessity for limiting the immunity, most of these tribunals have taken a moderate position, allowing suits only in situations in which the state has consented to the action or waived its immunity. Some courts following this trend have held that by entering into *any* contract the state waives its immunity and beomes liable for its breach.[12] Others limit this de-

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STRONG, N.C. INDEX 2D, *State* § 4 (1968); 72 AM. JUR. 2D *States, Territories & Dependencies* § 99 (1974).

5. *See* cases cited notes 12-13 *infra.*

6. W. PROSSER, HANDBOOK OF THE LAW OF TORTS 970 (4th ed. 1971); 72 AM. JUR. 2D *States, Territories & Dependencies* § 99 (1974).

7. Several commentators have attributed the interjection of the common-law doctrine into the law of the newly formed states to the debt-ridden financial condition of these governments during the period immediately following the Revolutionary War. *See, e.g.*, Gellhorn & Schenck, *Tort Actions Against the Federal Government*, 47 COLUM. L. REV. 722 (1947).

8. *See* text accompanying notes 28-31 *infra.*

9. O'Neill v. State Highway Dep't, 50 N.J. 307, 235 A.2d 1 (1967); Lyon & Sons, Inc. v. State Bd. of Educ., 238 N.C. 24, 76 S.E.2d 553 (1953).

10. *See* Evans v. Board of County Comm'rs, 174 Colo. 97, 482 P.2d 968 (1971).

11. *See, e.g.*, N.C. GEN. STAT. §§ 143-291 to -300.1 (1974). This distinction between types of governmental activity and the attendant variations in application of sovereign immunity have been fairly well developed and will not be dealt with here.

12. *E.g.*, Ace Flying Serv., Inc. v. Colorado Dep't of Agriculture, 136 Colo. 19, 314 P.2d 278 (1957); Regents of Univ. Sys. v. Blanton, 49 Ga. App. 602, 176 S.E. 673 (1934) (action by professor on an employment contract); Carr v. State *ex rel.* du Coet-

parture from the general rule of immunity to those contracts that are *legislatively authorized.*[13]

In the face of this modern trend, the North Carolina courts have uniformly been very hesitant to abrogate sovereign immunity in contract cases.[14] For example, in *General Electric Co. v. Turner*[15] the North Carolina Supreme Court stated: " 'It is axiomatic that the sovereign cannot be sued in its own court or any other without its consent and permission. . . . [This is] an established principle of jurisprudence in all civilized nations.' "[16] This immunity is absolute and unqualified "unless by statute [the State] has consented to be sued or has *otherwise waived its immunity.*"[17] The rule, however, has been even more restrictive in North Carolina than in other states as a result of the holding that consent cannot be implied from any act of the government, but must be expressly given.[18]

While a cursory view of the North Carolina precedent indicates that the State courts are unalterably devoted to this strict version of the doctrine of sovereign immunity, the supreme court did recognize the trend toward abrogation of the rule as early as 1953. In *Lyon & Sons, Inc. v. State Board of Education*[19] the court characterized the rule as "monarchistic" and unjust. It did not, however, change the rule, but instead, shifted the burden of any reform to the legislature.[20]

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losquet, 127 Ind. 204, 26 N.E. 778 (1891); Meens v. State Bd. of Educ., 127 Mont. 515, 267 P.2d 981 (1954) (action by professor against state for breach of employment contract).

13. *E.g.*, George & Lynch, Inc. v. State, 57 Del. 158, 197 A.2d 734 (1964) (action against the state for breach of a highway contract); V.S. DiCarlo Constr. Co. v. State, 485 S.W.2d 52 (Mo. 1972) (action against the state for breach of a construction contract for the building of State Government Emergency Operations Center).

14. J. STRONG, 2D, *supra* note 4.

15. 275 N.C. 493, 168 S.E.2d 385 (1969).

16. *Id.* at 498, 168 S.E.2d at 389, *quoting* Schloss v. State Highway Comm'n, 230 N.C. 489, 491, 53 S.E.2d 517, 518 (1949).

17. Lincoln Constr. Co. v. Property Control & Constr. Div. of the Dep't of Administration, 3 N.C. App. 551, 553, 165 S.E.2d 338, 339 (1969) (action for "extras" allegedly due under a grading and paving contract with the state) (emphasis added); Nello L. Teer Co. v. Highway Comm'n, 265 N.C. 1, 9, 143 S.E.2d 247, 253 (1965).

18. Orange County v. Heath, 282 N.C. 292, 192 S.E.2d 308 (1972).

19. 238 N.C. 24, 76 S.E.2d 553 (1953).

20. Indeed, this tactic has been much used by courts that have felt the need for reform in the law, but that have not wished to carry the burden of such change. The rule of sovereign immunity is, however, a judicial contribution to the law of the states, and there is therefore no technical reason why the abrogation of the doctrine, in whole or in part, could not come about through the initiative of the courts. Furthermore, legislative inaction in the face of condemnatory language such as that used in *Lyon & Sons* should, in some degree, educate the courts about the efficiency of leaving much needed change to the legislatures whose time has been consumed with other concerns. At least two courts, after waiting for the legislative bodies in their respective states to

More than twenty years later, in *Smith v. State*,[21] the court of appeals defined the "or otherwise waives its immunity" language[22] in a manner that limited the inequitable rule of sovereign immunity in North Carolina. The court reasoned that an express statutory authorization for entering into contracts for a term of years carries with it "by logical implication a waiver of sovereign immunity from a suit for breach" of that contract.[23] The court felt that to rule otherwise would indicate that the legislature could approve contracts that are binding on a citizen but not on the State. The court was unwilling to assume that the legislature intended this untenable result.[24] In addition, the court of appeals observed that "a truly democratic government should be required to observe the same rules of conduct that it requires of its citizens."[25]

By finding an *implied* waiver of immunity in legislative authorization to enter into contracts, thus precluding dismissal of actions against the State on the ground of sovereign immunity, the appellate court apparently overlooked the requirement of *express* consent to suit that had been enunciated by the supreme court.[26] In doing so, the court seems to have exceeded its judicial authority.[27] There is, however, a semantic distinction that would allow the court of appeals to reach that conclusion without departing from the rule prescribed by the supreme court. The "express" consent limitation had been applied by the supreme court to consents to suit only. Therefore, the alternative ground for refusing to dismiss suits against the State—a waiver of immunity—is technically free of the restriction. While this argument admittedly favors form over substance, it is one way in which the North Carolina

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act in this area, have taken the first step in correcting the injustices that flow from a narrow application of the doctrine. *See, e.g.*, Stone v. Highway Comm'n, 93 Ariz. 384, 393, 381 P.2d 107, 113 (1963) ("This doctrine having been engrafted upon Arizona law by judicial enunciation may properly be changed or abrogated by the same process."); Kersten Co. v. Department of Social Servs., 207 N.W.2d 117 (Iowa 1973); Pierce v. Yakima Valley Memorial Hosp. Ass'n, 43 Wash. 2d 162, 260 P.2d 765 (1953).

21. 23 N.C. App. 423, 209 S.E.2d 336 (1974).

22. *See* text accompanying note 17 *supra*.

23. 23 N.C. App. at 426, 209 S.E.2d at 338.

24. *Id.; accord,* George & Lynch, Inc. v. State, 57 Del. 158, 197 A.2d 734 (1964); Kersten Co. v. Department of Social Servs., 207 N.W.2d 117 (Iowa 1973).

25. 23 N.C. App. at 426, 209 S.E.2d at 338.

26. *See* text accompanying note 18 *supra*.

27. Generally, a court inferior in position to one having rendered a decision that is cited as precedent on appeal is bound by the higher court adjudication, regardless of the correctness of that decision. Nonetheless, many decisions of lower courts that deviate from this rule are vindicated when the higher court sustains the intermediate court's departure from precedent. *See* 20 AM. JUR. 2D *Courts* § 201 (1965) and cases cited therein.

courts can introduce an element of beneficial flexibility into the law, allowing protection from spurious suits on one hand and providing, on the other hand, relief in those situations in which the State can justifiably be held accountable for its wrongdoings.

Ultimately, the decision to change the law in North Carolina must rest upon policy considerations. Modern courts have based their application of the doctrine of sovereign immunity upon various foundations, including fiscal concerns, conceptual rationalizations and mere expediency. Among the more meritorious arguments presented in favor of the doctrine are concerns about the drain upon the public treasury that would result from compensation of private injuries[28] and the potential interference with the administration of public business.[29] While both of these arguments present valid concerns, one cannot overlook the fact that the suits and resultant drain upon state funds are, in these cases, occasioned by the alleged misdeeds of state officials or their agents. Any rule that flatly denies a plaintiff recovery for such wrongdoings ultimately damages the government in a manner far greater than a justified expenditure of public funds by reducing public respect for the governing body.[30]

Furthermore, the basic principles of contract law dictate that the traditional view of governmental immunity be reconsidered. It must be assumed that in authorizing the State to enter into contracts, the State constitution and legislature contemplated the State's involvement in *valid* contracts.[31] Traditionally, contracts are valid only when there is mutuality of obligations between the parties.[32] Otherwise, one or both of the parties would be free to refuse to perform, thus depriving

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28. *E.g.*, Orange County v. Heath, 282 N.C. 292, 296, 192 S.E.2d 308, 311 (1972); W. PROSSER, *supra* note 6, at 975.

29. Glasman v. Glasman, 309 N.Y. 436, 440, 131 N.E.2d 721, 723 (1956); Mikva, *Sovereign Immunity: In a Democracy the Emperor Has No Clothes*, 1966 ILL. L.F. 828, 829.

30. Other arguments for the doctrine are less persuasive. Several courts have had difficulty resolving the conceptual contradiction between the idea of supreme executive power and private suits against the State. Others have seen the idea of an entire people committing one wrong as a logical "absurdity." Yet another argument is based upon the idea that a state can do no wrong (replacing the earlier regal version of the tenet) and that therefore an agent of the State always acts "ultra vires" when committing a wrongful act. Least convincing are those applications of the rule based upon the embarrassment such liability would cause the government. None of these arguments stands up in the face of the need for responsible government and compensation for wrongful injury. *See* W. PROSSER, *supra* note 6, at 975.

31. George & Lynch, Inc. v. State, 57 Del. 158, 197 A.2d 734 (1964); *cf.* Smith v. State, 23 N.C. App. 423, 209 S.E.2d 336 (1974).

32. 1 S. WILLISTON, CONTRACTS § 1 (3d ed. 1957).

the agreement of its contractual nature.[33] The operation of sovereign immunity in this area has this effect. Such a result ascribes "bad faith and shoddy dealing to the sovereign."[34] Yet, few would argue that in such situations the private party would be allowed to breach the contract with impunity. Nevertheless, the logical conclusion of the argument that relieves the State of its obligations under a contract is just that: if one party is not bound, neither is the other.

The North Carolina Supreme Court will be called upon to further review the disposition of *Smith v. State*.[35] In doing so, the court will be faced with three options: first, the court may construe the "express" limitation to apply in all circumstances and reiterate the prior law in this clarified form; secondly, the court may rule that by entering into legislatively authorized contracts the State impliedly consents to suit or waives its immunity (the approach taken by the court of appeals); or, thirdly, the court may abolish sovereign immunity in North Carolina.

The first option is undesirable. By refusing to modify the law, the court would continue the inequities of a system in which the State is free to breach its contracts with impunity and in which governmental responsibility is sacrificed to the unjustified continuation of an archaic rule.

The second option is more desirable in two aspects. Primarily,

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33. It is frequently stated that to make an enforceable contract, there must be "mutuality of obligation." Horton v. Humble Oil & Ref. Co., 255 N.C. 675, 122 S.E.2d 716 (1961) (obligation must in general be mutual); Smith v. Barnes, 236 N.C. 176, 72 S.E.2d 216 (1952) (no mutuality, no contract); Kirby v. Stokes County Bd. of Educ., 230 N.C. 619, 55 S.E.2d 322 (1949) (an essential element of every contract). The concept is a semantic one referring to the idea of consideration which underlies the law of contracts. Clausen & Sons, Inc. v. Theo. Hamm Brewing Co., 395 F.2d 388 (8th Cir. 1968). It seems, however, that this mutuality is *not* essential to *every* contract. An embodiment of the consideration principle, mutuality of obligation is necessary only when there is no other consideration supporting one party's promise. Each promise then becomes consideration for the other. McCraw v. Llewellyn, 256 N.C. 213, 123 S.E.2d 575 (1962). When there is any other consideration for the contract, so that each promise does not depend wholly upon the other for its consideration, mutuality of obligation is not essential. The test is whether legal liability is imposed upon the promisor for breach of his promise. This test should be applied as of the time one of the promises is sought to be enforced, not at the time the promises are made. Hutchings v. Slemons, 141 Tex. 448, 452, 174 S.W.2d 487, 489 (1943). In the case in question, at the time of enforcement of the employment contract, the doctrine of sovereign immunity prevents the plaintiff from enforcing the State's promise, which was the only consideration for his promise to perform as superintendent of Broughton Hospital. There is, therefore, no mutuality of obligation, *i.e.* consideration, on the part of the State and the contract is therefore not binding on either party.

34. Kersten Co. v. Department of Social Servs., 207 N.W.2d 117, 120 (Iowa 1973).

35. 23 N.C. App. 423, 209 S.E.2d 336 (1974).

by holding that the State impliedly waives its immunity from suit in limited situations, the supreme court could retain the benefits of the doctrine—an opportunity to protect the public funds and administration from spurious suits—while relieving the system of the inequities that have previously resulted from the strict application of the common law rule. In addition, this course would allow a desirable change in the law without the disruption caused by overturning numerous prior decisions.

The third choice is probably the most unlikely. Total abrogation of the doctrine of sovereign immunity appears to be too great a step even for those courts bent upon reform.[36] Additionally, total departure from previous law is not necessary to dispose of this case justly. Nevertheless, this course seems to be the most desirable. By removing the protective armor that surrounds the State and shields it from responsibility for its wrongful acts, the court might move the legislature to enact a system of governmental responsibility and claims processing. Undoubtedly, such judicial action would be more effective in this area than the unheeded hints already given.[37] But more importantly, such a ruling would give the concept of governmental responsibility an effectiveness lacking in any system that allows the sovereign to abuse its citizens without liability.

H. KING MCGLAUGHON, JR.

Taxation—Out-of-State Distributors Versus the North Carolina Soft Drink Tax: The Battle May Not Be Over

In *Richmond Food Stores, Inc. v. Jones*[1] the North Carolina Court of Appeals summarily affirmed a superior court decision declaring unconstitutional a section of the North Carolina Soft Drink Tax Act.[2] The provision in issue, entitled "Alternative method of payment of

36. *See* text accompanying notes 10-13 *supra.*
37. *See* text accompanying notes 19-21 *supra.*

1. 22 N.C. App. 272, 206 S.E.2d 346 (1974).
2. N.C. GEN. STAT. §§ 105-113.41-.67 (1972). This writer's research has disclosed only three other states with equivalent soft drink tax statutes: Louisiana, South Carolina, and West Virginia. LA. REV. STAT. §§ 47:881-:908 (1970); S.C. CODE ANN. §§ 65-751 to -782 (1962); W. VA. CODE ANN. §§ 11-19-1 to -11 (1974).

tax,"[3] allowed resident distributors or wholesale dealers of "bottled"[4] soft drinks to pay the tax at one-half of the rate charged out-of-state distributors, who shipped soft drinks into the State for sale. It also provided that resident distributors could remit the tax monthly with accompanying sales reports, whereas nonresidents were required to pay the tax through the more time-consuming and expensive method of purchasing and affixing a tax stamp or crown to each bottled drink. Both the court of appeals and lower court regarded the provision as a discrimination against interstate commerce, violating article I, section 8, clause 3 of the United States Constitution—the commerce clause.[5]

Significantly, *Richmond Food Stores* does not address the equally important question of when—consistent with commerce clause restrictions—North Carolina can levy *any* tax on a nonresident distributor. More specifically, the commerce clause bars a state tax on the privilege of doing interstate business.[6] A convincing argument can be made that a nonresident distributor, who merely solicits orders in North Carolina, accepts them out-of-state, and then delivers the goods to his customers, is engaged in purely interstate business.

Richmond Food Stores, Inc. is a Virginia cooperative, engaged in the business of wholesale food distribution.[7] The company distributes grocery items in several states,[8] including North Carolina in which it services thirty to thirty-five independent food retailers.[9] One item distributed is "Shasta" bottled and canned soft drinks for which the company is subjected to the North Carolina soft drink tax.[10] According to the trial testimony of a Department of Revenue official, Richmond Foods is one of about fifty to seventy-five out-of-state distributors shipping bottled soft drinks into North Carolina.[11]

3. N.C. GEN. STAT. § 105-113.56A (1972).

4. "Bottled," as statutorily defined, "means enclosed in any closed or sealed glass, metal, paper or other type of bottle, can, carton or container, regardless of the size of such container." *Id.* § 105-113.44(2). Thus, canned soft drinks fall within the definition of "bottled."

5. Although both courts declared the discrimination in the "Alternative method of payment of tax," *id.* § 105-113.56A, to be unconstitutional, neither court voided the provision entirely. Rather, the courts merely rejected the distinction between residents and nonresidents. The practical effect of *Richmond Food Stores* is to allow nonresidents to use the "Alternative method of payment of tax."

6. *E.g.*, Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 461-62 (1959); Spector Motor Serv., Inc. v. O'Connor, 340 U.S. 602 (1951); Alpha Portland Cement Co. v. Massachusetts, 268 U.S. 203 (1925).

7. Record at 2.

8. *Id.*

9. *Id.* at 31.

10. *Id.*

11. *Id.* at 20.

The North Carolina Soft Drink Tax Act, enacted in 1969, is purely a revenue, rather than a regulatory, measure.[12] The Act labels the tax it imposes as a "license" tax on the privilege of "doing domestic or intrastate business . . . [in] selling, manufacturing, purchasing, consigning, using, shipping or distributing, for the purpose of sale within this State, soft drinks of every kind whatsoever . . . ."[13] The tax is levied at a per unit rate on soft drinks and on soft drink syrups, powders, and base products;[14] it is measured by the number of sales of each commodity within the State.[15] The basic rate of tax on the privilege of distributing "bottled" soft drinks (the issue in *Richmond Food Stores*) is one cent per bottle.[16] The basic method of paying the tax is through the purchase of tax stamps or crowns, which are required to be affixed to each bottle within twenty-four hours of its receipt or manufacture in the State.[17] Peculiarly, the Act—before *Richmond Food Stores*—permitted resident distributors or wholesale dealers of bottled soft drinks to use an alternative method of payment[18] under which they would pay one-half of the basic per bottle rate[19] and would

12. N.C. GEN. STAT. § 105-113.42 (1972). The section declares, "It is the purpose of this Article to provide a source of additional revenue which shall be applied to the general fund of the State."

13. *Id.* § 105-113.43.

14. *Id.* § 105-113.45.

15. *Id.* § 105-113.43.

16. *Id.* § 105-113.45.

17. *Id.* § 105-113.51(a).

18. *Id.* § 105-113.56A. The section reads as follows:

> **§ 105-113.56A. Alternative method of payment of tax**—Instead of paying the tax levied in this Article in the manner otherwise provided, any resident distributor or wholesale dealer, and any distributor or wholesale dealer having a commercial domicile in this State may pay the tax in the following manner, with respect to bottled soft drinks:
>
> Beginning with sales made on and after October 1, 1969, of bottled soft drinks subject to the tax, sales reports shall be made to the Commissioner on or before the fifteenth day of each succeeding month, accompanied by payment of the tax due, determined as follows: For the first fifteen thousand gross of bottled soft drinks sold annually, seventy-two (72¢) per gross; for all in excess of fifteen thousand gross, one cent (1¢) per bottle. In addition, there shall be allowed a discount of eight percent (8%) of the said tax to be remitted.
>
> All persons paying the tax in this manner shall be subject to such rules and regulations as the Commissioner may prescribe, including the requirement that such persons furnish such bond as the Commissioner may deem advisable, in such amount and upon such conditions as in the opinion of the Commissioner will adequately protect the State in the collection of the taxes levied by this Article.

19. The tax rate under the "Alternative method of payment of tax" is $.72 per gross (one gross = 144 bottles) or $.005 per bottle for the first 15,000 gross (2,160,000 bottles) sold in the State. All sales over 15,000 gross are taxed at the basic rate of $.01 per bottle. Thus, a resident distributor, before the *Richmond Food Stores* decision, paid only $10,800 tax on his first 15,000 gross of sales. In comparison, a nonresident distributor like Richmond Food Stores paid $21,600 tax on the first 15,000 gross.

At the trial, a Richmond Food Stores official testified that his company had never

avoid the use of tax stamps and crowns altogether.[20]

Under the Soft Drink Tax Act, each bottled soft drink is subject to taxation only once. The Act places tax liability on one of the following: the distributor or dealer "who first distributes, sells, uses, consumes or handles" the product unless stamps or crowns are already affixed; the first consignee if the goods are shipped into the State by common carrier; or the person who brings the soft drinks into the State.[21] Richmond Food Stores, as the first distributor of soft drinks within the State and also as the person bringing soft drinks into the State, was assessed with tax liability. Since it distributed soft drinks "for the purpose of sale within this State,"[22] the company apparently believed it

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reached the 15,000 gross level of sales in North Carolina. Record at 35. Thus, on each sale his company made in North Carolina, they were assessed twice the amount of tax levied on a resident.

20. Although the State contended initially that tax stamps and crowns were vital to enforcement of the soft drink tax against nonresidents, cross-examination at trial of a Department of Revenue official revealed that stamps and crowns served no useful purpose. Since most resident distributors did not use stamps or crowns, the absence of a tax stamp on a soft drink can in a supermarket indicated nothing about whether a tax had been paid. *Id.* at 21-22. Stamps and crowns are only useful if everyone is required to use them; otherwise, a tax official has to rely exclusively on sales reports to determine if tax has been paid.

The difficulties involved in using tax stamps are described in the trial testimony of a Richmond Food Stores official. In the first place, the stamps could not be applied by machine; each stamp had to be pealed from its backing by hand and then affixed to the individual bottle or can. Secondly, since Richmond Food Stores was a comparatively small company it could not maintain separate inventories of each of its products. Therefore, when an order of soft drinks, subject to the North Carolina tax, was ready for shipment, each case had to be broken open, the stamps applied, and the case resealed. This process created delays in shipment (especially when an order was for four or five hundred cases of drinks) and cost the company considerable employee hours of wages. *Id.* at 32-33.

It is true that the difficulties encountered with tax stamps could have been avoided by the use of tax crowns or lids. Apparently, Richmond Food Stores was too small to convince its manufacturer to use tax paid lids or crowns. The Richmond Food Stores official testified: "We could use tax paid lids if we could get Shasta to make a special run for North Carolina and stamp it for us, but I can't imagine what the cost might be if you stop the machines at the Shasta factory and changed over to a Carolina lid." *Id.* at 35.

21. N.C. GEN. STAT. § 105-113.51(b) (1972). The exact language of the subsection is as follows:

> (b) The distributor or dealer who first distributes, sells, uses, consumes or handles bottled soft drinks, syrups, powders, base products, and other items subject to the soft drink excise tax is subject to the tax unless taxpaid stamps or crowns have previously been affixed. The distributor, wholesale dealer or retail dealer, or any person who is the original consignee of any bottled soft drink, soft drink syrup, powder, base product or other item subject to the soft drink excise tax manufactured or produced outside this State, or who brings such into this State, shall pay the excise tax.

The textual statement that liability falls on the first consignee when goods are shipped into the State by common carrier is an administrative interpretation of subsection (b). Record at 20-21.

22. N.C. GEN. STAT. § 105-113.43 (1972).

was within the group of persons subject to the tax. Therefore, it conceded liability for some tax,[23] but challenged the discriminatory rates and the discriminatory method of tax payment, resting its arguments largely on the commerce clause of the United States Constitution.[24]

THE SCOPE OF COMMERCE CLAUSE PROTECTION

In drafting the commerce clause,[25] the framers of the Constitution recognized that free trade between the states, unburdened by discriminatory and retaliatory acts against commerce, was essential to national economic unity.[26] The purpose of the clause was not merely to vest regulatory power with the federal government but to insulate commerce from unwarranted state interference—in effect to create a national "common market."[27] Although the United States Supreme Court quite early made the two-step determination that taxation is a form of regulation[28] and that the commerce clause was designed to limit state regulation of trade,[29] the Court's use of the clause to invalidate state taxes is of comparatively recent origin,[30] beginning with the *Case of the State Freight Tax*[31] in 1872. In the ensuing years,

23. This concession will be examined thoroughly later in the note. This writer has considerable doubt as to whether Richmond Food Stores was "doing domestic or intrastate business" as required by *id.*

24. The company also argued that the "Alternative method of payment of tax" violated the due process and equal protection clauses of the fourteenth amendment of the federal constitution as well as provisions of the North Carolina Constitution. These arguments are not discussed by the court of appeals in the *Richmond Food Stores* decision and were not a basis of the court's holding. Accordingly, they are not discussed in this note.

25. U.S. CONST. art. I, § 8, cl. 3. The commerce clause states, "the Congress shall have Power . . . To regulate Commerce with foreign Nations, and among the several States, and with the Indian tribes . . . ."

26. THE FEDERALIST NOS. 7, 11, 22 (A. Hamilton); THE FEDERALIST NO. 42 (J. Madison); Celler, *The Development of a Congressional Program Dealing with State Taxation of Interstate Commerce*, 36 FORDHAM L. REV. 385 (1968); Hartman, *State Taxation of Interstate Commerce: A Survey and an Appraisal*, 46 VA. L. REV. 1051, 1053-55 (1960); *Developments in the Law—Federal Limitations on State Taxation of Interstate Business*, 75 HARV. L. REV. 953, 956 (1962).

27. *See* authorities cited note 26 *supra*.

28. *See* McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 425-37 (1819).

29. Brown v. Maryland, 25 U.S. (12 Wheat.) 419, 445-49 (1827).

> It may be doubted whether any of the evils proceeding from the feebleness of the federal government, contributed more to that great revolution which introduced the present system, than the deep and general conviction, that commerce ought to be regulated by Congress. It is not, therefore, a matter of surprise, that the grant should be as extensive as the mischief, and should comprehend all foreign commerce, and all commerce among the States.

Id. at 446.

30. J. HELLERSTEIN, STATE AND LOCAL TAXATION: CASES AND MATERIALS 163 (1969).

31. 82 U.S. (15 Wall.) 232 (1872) (unconstitutional to levy tax on goods in interstate transit).

cases challenging state taxes on commerce clause grounds have forced the Court to balance state needs for revenue against the national interest in free trade.[32] As a general rule, the Court recently has been sympathetic to state needs, and it has significantly narrowed the area of tax exempt interstate commerce despite considerable opposition from the business community and Congress.[33]

Although as a general proposition it may be said that Supreme Court decisions dealing with state taxation of interstate commerce are impossible to reconcile,[34] the decisions do uniformly condemn state taxes that discriminate against interstate business. Typical of state tax laws voided as discriminatory against interstate commerce are the following: laws exempting local goods, thus leaving only commodities from out-of-state subject to the tax;[35] laws taxing nonresident merchants but exempting the chief local competitors;[36] and laws charging higher tax rates to nonresidents.[37] The policy behind the condemnation of discriminatory taxation is succinctly expressed by the Supreme Court in *Best & Co. v. Maxwell*: "The freedom of commerce which

32. "The power of the States to tax and the limitations upon that power imposed by the Commerce Clause have necessitated a long, continuous process of judicial adjustment." Freeman v. Hewit, 329 U.S. 249, 251 (1946).

33. *E.g.*, Scripto, Inc. v. Carson, 362 U.S. 207 (1960) (out-of-state vendor with limited contact responsible for collection of state use tax); Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959) (interstate business subject to state income tax). Reaction by the business community to these decisions was vehement, and there was considerable debate in Congress on the whole question of state taxation of interstate commerce. For a discussion of the congressional debate see Celler, *supra* note 26, at 385; Mickey & Mickum, *Congressional Regulation of State Taxation of Interstate Commerce*, 38 N.C.L. REV. 119 (1960).

The only legislation produced by the congressional debate, 15 U.S.C. §§ 381-84 (1970), imposes a narrow restriction on state income taxation of interstate business. Basically, the statute prohibits an income tax on the vendor of tangible personal property who merely solicits orders in the taxing state, accepts or rejects them out of state, and if accepted, delivers by shipment directly to his customers. *Id.* § 381(a)(1).

34. "The history of this problem is spread over hundreds of volumes of our Reports. To attempt to harmonize all that has been said in the past would neither clarify what has gone before nor guide the future." Freeman v. Hewit, 329 U.S. 249, 252 (1946). For excellent surveys on the entire subject of state taxation of interstate commerce see W. BEAMAN, PAYING TAXES TO OTHER STATES (1963); P. HARTMAN, STATE TAXATION OF INTERSTATE COMMERCE (1953); *Symposium—State Taxation of Interstate Commerce*, 46 VA. L. REV. 1051 (1960).

35. I.M. Darnell & Son Co. v. City of Memphis, 208 U.S. 113 (1908) (products of Tennessee soil exempt from property tax); Guy v. City of Baltimore, 100 U.S. 434 (1879) (vessels unloading Maryland products not charged wharfage fee); Welton v. Missouri, 91 U.S. 275 (1875) (peddler selling "growth, produce or manufacture" of state exempt from license tax).

36. West Point Wholesale Grocery Co. v. City of Opelika, 354 U.S. 390 (1957); Nippert v. City of Richmond, 327 U.S. 416 (1946); Best & Co. v. Maxwell, 311 U.S. 454 (1940).

37. Memphis Steam Laundry Cleaner, Inc. v. Stone, 342 U.S. 389 (1952).

allows the merchants of each state a regional or national market for their goods is not to be fettered by legislation, the actual effect of which is to discriminate in favor of intrastate businesses, whatever may be the ostensible reach of the [statutory] language."[38]

Richmond Food Stores is not the first recognition by a North Carolina court of the commerce clause's protection against discriminatory taxation. In 1879 the North Carolina Supreme Court voided a tax levied on a resident grocer for the amount of his out-of-state purchases.[39] The decision expressly overruled an earlier North Carolina case that had sustained a discriminatory tax on "spirituous" liquors.[40] More recently, the North Carolina Supreme Court reaffirmed the principle against discriminatory taxation of interstate commerce in *Billings Transfer Corp. v. County of Davidson.*[41] In that case the court found property of a resident trucking company to be subject to a county ad valorem property tax despite a commerce clause challenge, but in dicta, the court emphasized that the tax was valid only as long as it was nondiscriminatory.[42]

In light of the solid line of precedent condemning discrimination by a state against commerce, *Richmond Food Stores* is clearly correct. The alternative method of payment, with its discriminatory rates and discriminatory reporting methods, directly contravened the commerce clause, and was probably intended to give a competitive advantage to the in-state distributor.

The most intriguing aspect of *Richmond Food Stores* is not the holding itself, but the potential argument on similar facts that out-of-state soft drink distributors are not constitutionally or statutorily subject to the soft drink tax at all. The statute expressly limits itself to persons who are "doing domestic or intrastate business within this State" and the tax is on the "privilege" of doing that business.[43] The statutory language seems to reflect a legislative awareness of commerce clause restrictions on taxation.[44] Decisions of the United States Supreme Court have condemned state "privilege" taxes on interstate business,

38. 311 U.S. 454, 457 (1940).
39. Albertson v. Wallace, 81 N.C. 479 (1879).
40. Davis v. Dashiel, 61 N.C. 114 (1867) (resident liquor dealer was required to pay 15% tax rate on liquor purchased out-of-state and 10% tax rate on liquor bought from a North Carolina manufacturer).
41. 276 N.C. 19, 170 S.E.2d 873 (1969).
42. *Id.* at 24, 170 S.E.2d at 877-78.
43. N.C. GEN. STAT. § 105-113.43 (1972).
44. Brief for Appellant at 5.

no matter how fairly the taxes in question are measured or apportioned.[45] The principle behind the decisions is that the "privilege" to engage in interstate commerce is given by the federal government and not by state governments.[46]

The problem confronting the Court in cases dealing with taxation of the interstate merchant has been to determine the line between *interstate* and *intrastate* business. To sustain a state "doing business" tax levied on an out-of-state seller, the Court has required some local activity, sufficiently separated from the purely interstate transaction.[47] An analysis of Supreme Court decisions provides some help in defining the elusive term "local activity."

Probably the most consistent line of decisions dealing with state privilege taxes are the "drummer" or itinerant salesman cases.[48] These cases have held that the mere solicitation of orders by an out-of-state merchant either through itinerant salesmen or a sales office within the taxing state is interstate business and is not subject to a state privilege tax. Apparently, the rationale of the decisions is that the free access of vendors to interstate markets is essential to a unified economy.[49]

The "drummer" decisions must be distinguished from another line of cases known as the "peddler" decisions.[50] These cases have sustained state privilege taxes on the out-of-state vendor who not only solicits orders, but also carries with him quantities of his product which

45. Spector Motor Serv., Inc. v. O'Connor, 340 U.S. 602 (1951); Alpha Portland Cement Co. v. Massachusetts, 268 U.S. 203 (1925).

46. Hartman, *supra* note 26, at 1091.

47. Dunbar-Stanley Studios, Inc. v. Alabama 393 U.S. 537 (1969); Norton Co. v. Department of Revenue, 340 U.S. 534 (1951); Cheney Bros. Co. v. Massachusetts, 246 U.S. 147 (1918).

48. The leading case in the long line of "drummer" decisions is Robbins v. Shelby County Taxing Dist., 120 U.S. 489 (1887). The decisions are collected in Memphis Steam Laundry Cleaner, Inc. v. Stone, 342 U.S. 389, 392-93 n.7 (1952).

49. W. BEAMAN, *supra* note 34, ch. 16, at 6.

50. *E.g.*, Caskey Baking Co. v. Virginia, 313 U.S. 117 (1941); Wagner v. City of Covington, 251 U.S. 95 (1919). The "peddler" cases are collected in Memphis Steam Laundry Cleaner, Inc. v. Stone, 342 U.S. 389, 394 n.12 (1952).

Wagner v. City of Covington *supra*, involved facts quite similar to *Richmond Food Stores*. Plaintiff in that case was a soft drink bottler in Cincinnati, Ohio who sold drinks to retailers across the Ohio River in Covington, Kentucky. He challenged a soft drink license tax imposed by the City of Covington on the grounds that he was engaged solely in interstate business and consequently, was protected by the commerce clause. In its decision, the Court distinguished between two types of sales activity conducted by the plaintiff bottler. The first type, where orders were received in Cincinnati and shipments were delivered directly to Kentucky customers, was interstate business and was not subject to a license or privilege tax. The second type, where the bottler merely loaded up his wagon and traveled from customer to customer taking and filling orders on the spot, was intrastate business and was subject to a privilege tax.

he sells directly to customers in the taxing state. By carrying the goods with him, the out-of-state vendor becomes in the Court's view simply another local merchant.[51] Thus actual selling, as distinguished from mere solicitation, is a local activity.

The rule of the "drummer" decisions—that mere solicitation is not local activity—extends to other aspects of the interstate sale. The Court has held that it is purely interstate business when a transaction contains only the following elements: (1) orders solicited by salesmen working out of a local sales office; (2) orders submitted to an out-of-state office for approval; (3) commodities shipped directly to the customer.[52] On the other hand, the Court has found some activities of the interstate vendor to be local in nature and properly to be subject to a state privilege tax. Distribution of goods through a local warehouse or local office rather than by direct shipment to the customer is local activity.[53] Likewise the maintenance of a local repair station to service the vendor's product,[54] the use of salesmen to assist the vendor's wholesale customers in making resales,[55] and the taking and *acceptance* of orders at a local office[56] have been held to be local activities.

Clearly some nonresident soft drink distributors will be engaged in local activities (local warehouse, acceptance of orders in North Carolina, etc.) that make them amenable to the North Carolina Soft Drink Tax Act. However, it is likely that others will merely solicit orders,

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51. Memphis Steam Laundry Cleaner, Inc. v. Stone, 342 U.S. 389, 394 (1952).

52. J. HELLERSTEIN, *supra* note 30, at 174; *see* Dunbar-Stanley Studios, Inc. v. Alabama, 393 U.S. 537, 539 (1969); Norton Co. v. Department of Revenue, 340 U.S. 534, 537 (1951); Cheney Bros. Co. v. Massachusetts, 246 U.S. 147, 153-54 (1918). Although the "drummer" decisions and the above-cited authorities firmly held that mere solicitation and delivery is interstate business immune from a privilege tax, the Supreme Court has recognized that sales activity can become sufficiently intense to transform it from solicitation into local activity. In General Motors Corp. v. Washington, 377 U.S. 436 (1964), the Court sustained the imposition of a privilege tax on General Motors, measured by a percentage of the company's gross receipts from sales to automobile dealers in the State of Washington. Orders from the dealers were sent outside the state to be accepted or rejected, and shipments were made to the dealers. However, General Motors maintained representatives in the taxing state who directly supervised and assisted dealers in their sales and service activity. The Court found a "maze of local connections" sufficient to take General Motors' activity out of the protection of the commerce clause.

53. Norton Co. v. Department of Revenue, 340 U.S. 534 (1951).

54. Cheney Bros. Co. v. Massachusetts, 246 U.S. 147, 154 (1918).

55. *Id.* at 155; *cf.* Eli Lilly & Co. v. Sav-On-Drugs, Inc., 366 U.S. 276 (1961).

56. Graybar Elec. Co. v. Curry, 308 U.S. 513, *aff'g per curiam* 238 Ala. 116, 189 So. 186 (1939); W. BEAMAN, *supra* note 34, ch. 12, at 3-4; *see* Wiloil Corp. v. Pennsylvania, 294 U.S. 169 (1935).

accept them out-of-state and then ship directly to their customers. This would appear to be interstate, not intrastate activity, leaving the distributors within the protection of the commerce clause and outside the statutory language of "doing domestic or intrastate business."[57]

If nonresident distributors are able to avoid payment of the soft drink tax on commerce clause grounds, there will be adverse consequences. First, the State will lose tax revenue. Secondly, and more importantly, the North Carolina soft drink industry will be left at a competitive disadvantage with its out-of-state rivals. The State must therefore find some constitutional method to tax the soft drinks distributed by an out-of-state seller although the seller himself is immune from taxation. Seemingly, out-of-state soft drinks can be taxed in at least two ways. The first way is simply to levy the present soft drink tax on the first North Carolina consignee of goods shipped from outside the State. This procedure is used by the State of South Carolina[58] which has a similar soft drink tax and is currently used by North Carolina when soft drinks are delivered to North Carolina by a common carrier.[59]

The second way to tax the soft drinks is to convert the tax from a privilege tax to a sales and use tax.[60] The sales and use tax has been sustained by the United States Supreme Court against commerce clause

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57. N.C. GEN. STAT. § 105-113.43 (1972). Neither the record nor the court of appeals decision in *Richmond Food Stores* is specific on the extent of that company's activities in North Carolina. Quite possibly the company was engaged in local activities. Therefore, no conclusion is offered about whether Richmond Food Stores itself was subject to the soft drink tax. It is merely suggested that some nonresident distributors may be able to avoid payment of the tax.

58. S.C. CODE ANN. § 65-768 (1962).

59. *See* note 21 and accompanying text *supra*.

60. A sales tax is a type of gross receipts or gross income tax, levied on the proceeds of a sale of tangible personal property. In its "pure form," the tax is imposed on the seller directly although he might have been able to pass the cost on to the buyer. W. BEAMAN, *supra* note 34, ch. 13, at 1. In McLeod v. J.E. Dilworth Co., 322 U.S. 327 (1944), the Supreme Court held that the out-of-state seller could not be assessed a sales tax if he accepted orders outside the taxing state and was engaged solely in solicitation and delivery within the taxing state.

A use tax is levied on the purchaser of tangible personal property, but frequently the seller is made the collection agent for the taxing state. He remits the tax to the state and is liable for the tax if he fails to collect it. Although the sales and use taxes may appear to be different in form and not in substance, with the seller paying the tax and attempting to pass it on to the buyer, there are important substantive differences. Under the use tax, the seller is merely the surety for the buyer's obligation. Thus, even if a state imposes tax liability on the seller for failure to collect the tax, he still has a right of recourse against the buyer. In addition, if the seller refuses to collect a use tax, the state may sue the buyer for the amount of tax due. In contrast, sales tax liability falls directly on the seller. Although he may try to pass the tax to the buyer, he has no legal right to do so. BEAMAN, *supra* note 34, ch. 13, at 7-8.

arguments.[61] Under this type of tax arrangement, North Carolina would levy a soft drink "use" tax on the resident purchaser of out-of-state soft drinks. However, the seller of the drinks would be required to collect the tax and to remit it to the State. At the same time, a sales tax would be levied on transactions between resident soft drink manufacturers and resident distributors. As long as the sales and use tax rates are the same (no discrimination), the commerce clause would not be violated since a use tax does not fall directly on the out-of-state seller.[62] In addition, local merchants would not be left at a competitive disadvantage. Finally, to insure against a successful commerce clause attack based on the burdensome administrative costs involved in collecting a use tax, North Carolina could allow the out-of-state seller to keep eight percent (the discount currently allowed by the alternative method of payment) of the tax he collects as a type of salary.[63]

CONCLUSION

The North Carolina Court of Appeals correctly determined in *Richmond Food Stores* that the alternative method of paying the North Carolina soft drink tax unconstitutionally discriminated against interstate commerce. However, the decision did not reach the issue of commerce clause restrictions against privilege taxes on interstate business.

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61. The sales tax has been employed effectively with a compensating use tax. Under the usual arrangement, the sales tax is levied on intrastate sales and the use tax is levied on purchasers of out-of-state products. The use tax therefore is a means to avoid sales tax weaknesses created by the commerce clause. J. HELLERSTEIN, *supra* note 30, at 237-38. This type of arrangement has been sustained by the Supreme Court, particularly if the out-of-state seller is allowed to keep a portion of the tax he collects to cover administrative costs. *E.g.*, Scripto, Inc. v. Carson, 362 U.S. 207 (1960); General Trading Co. v. State Tax Comm'n, 322 U.S. 335 (1944); Henneford v. Silas Mason Co., 300 U.S. 577 (1937).

62. Although the Supreme Court has been more willing to sustain a use tax than a sales or privilege tax levied directly on the seller, the Court has still required some minimum local activity. In its most liberal use tax decision, the Court held that a Georgia firm, using a small number of independent contractors to solicit orders in the taxing state, could be required to collect a Florida use tax. Scripto, Inc. v. Carson, 362 U.S. 207 (1960). Two other Supreme Court decisions have held that a seller did not have enough local activity to be required to collect a use tax: National Bellas Hess, Inc. v. Department of Revenue, 386 U.S. 753 (1967) (mail order firm with no solicitors in taxing state and deliveries made by common carrier or the mail); Miller Bros. Co. v. Maryland, 347 U.S. 340 (1954) (department store with no solicitation in taxing state and deliveries made in company's own trucks). Out-of-state soft drink distributors would appear to have more local activity than a mail order or department store although it is possible to make the contrary argument. Seemingly, regular solicitation of orders and delivery to regular customers would be enough local activity to require the distributor to collect a use tax.

63. *See* Scripto, Inc. v. Carson, 362 U.S. 207 (1960).

In this writer's view, a nonresident soft drink distributor who solicits orders by catalog or through salesmen, accepts them out-of-state, and then ships directly to his North Carolina customers is constitutionally and statutorily exempt from the present Soft Drink Tax Act.[64]

Although the out-of-state seller may be beyond the State's taxing jurisdiction, his goods are not. Therefore, the State legislature should amend the Soft Drink Tax Act, placing tax liability on the resident purchaser. This action would protect interstate commerce, the local merchant, and State tax revenue.

PAUL M. DENNIS, JR.

64. In a decision delivered since the completion of this note, the United States Supreme Court sustained the imposition of a business and occupation tax, measured by a percentage of the gross receipts from sales, on an out-of-state manufacturer whose only "local" connection with the taxing state was one resident employee. Standard Pressed Steel Co. v. Washington Dep't of Revenue, 95 S. Ct. 706 (1975). The resident employee (an engineer) served as liaison between the out-of-state company, a manufacturer of aircraft fasteners, and its principal customer in the State of Washington, Boeing Aircraft. The engineer did not take sales orders; rather, orders were sent directly to the manufacturer, and shipments were made to Boeing by common carrier. The employee's duties were to obtain the engineering design of fasteners needed, to secure the testing of sample products, to resolve problems after sale, and to maintain the good will of Boeing personnel. *Id.* at 708.

The Court felt that General Motors Corp. v. Washington, 377 U.S. 436 (1964), was directly controlling. *See* note 52 *supra*. Apparently the Court was unwilling to distinguish between district sales and service representatives supervising independent automobile dealers (the facts of *General Motors*) and a single engineer participating extensively in the purchasing decisions of a principal customer (facts of *Standard Pressed Steel*).

Since the opinion in *Standard Pressed Steel* is very brief and contains only a cursory analysis of prior precedent, it is difficult to determine the full implications of that decision. Possibly, the decision can be interpreted to overturn the "drummer" cases and to stand for the proposition that a seller's use of local salesmen in a taxing state is sufficient activity to sustain the imposition of a privilege tax. However, this interpretation seems unlikely. It is more plausible to conclude that the Court viewed an engineer-consultant, living in the taxing state, as qualitatively different from a mere salesman.

In light of two Supreme Court decisions—West Point Wholesale Grocery Co. v. City of Opelika, 354 U.S. 390 (1957) and Wagner v. City of Covington, 251 U.S. 95, 100-01 (1919)—that directly reject the imposition of a privilege tax on nonresident wholesale grocery distributors who do nothing but solicit orders and deliver commodities, and in view of the consistent line of "drummer" cases, this writer still believes that many nonresident soft drink distributors can avoid payment of the North Carolina soft drink tax. This position derives considerable support from a recent opinion by Mr. Justice Douglas, the author of the majority opinion in *Standard Pressed Steel*. In United Air Lines, Inc. v. Mahin, 410 U.S. 623, 637-38 (1973) (sustaining use tax on aircraft fuel) (Douglas, J., dissenting), Justice Douglas reaffirmed the proposition that solicitation of orders and the resulting shipment of goods by an out-of-state firm is an insufficient basis to levy a tax on the firm. He also acknowledged that the use tax was conceived as a means to complement a sales tax, "*i.e.*, to fill in gaps where the States could not constitutionally tax interstate arrivals or departures." *Id.* at 638.

The traditional approach to taxing the interstate seller—levy a use tax but not a sales or privilege tax—stated by Mr. Justice Douglas in *United Air Lines* is the one taken in this note, and this writer believes it is still valid after Standard Pressed Steel Co. v. Washington, *supra*.

Taxation—Personal Property Owned by Nonresidents: Taxable While at a North Carolina Manufacturing Plant?

In *In re Hanes Dye & Finishing Co.*[1] the Supreme Court of North Carolina determined that certain unfinished textile goods, owned by non-North Carolina residents, were not taxable by the county in which they were physically located. These goods, temporarily in North Carlina for processing by a resident finishing company, were admittedly in the State on the day for listing property for taxation. Yet, as a result of the decision, the goods escaped taxation by North Carolina since only the county in which they were located had any connection with them. Potentially, the decision could exclude much of the personal property owned by nonresident corporations and individuals from this State's property tax base.

The case arose when Forsyth County sought to tax unfinished cloth that had been shipped to the Hanes Dye and Finishing Company[2] to be processed.[3] Many owners[4] of the cloth were nonresidents of North Carolina who had purchased the goods in other states and had shipped them to North Carolina for finishing by Hanes.[5] These owners planned to reship the finished cloth to buyers in other states.[6] Hanes' possession of the goods, therefore, was only one step in a multi-state industrial process, and the cloth was only temporarily in its possession.[7]

Unfortunately for Hanes and its customers, the cloth was phys-

1. 285 N.C. 598, 207 S.E.2d 729 (1974).

2. The Hanes Dye and Finishing Co. is a North Carolina corporation with its principal office and place of business in Winston-Salem, Forsyth County. Its only plant is located in Winston-Salem. *Id.* at 600, 207 S.E.2d at 731.

3. Hanes "is sometimes referred to in the industry as a commission finisher, meaning that it is commissioned to do dyeing and finishing of cloth for its customers." *Id.*

4. The cloth's owners are known as "converters" in the textile industry. A "converter" obtains a contract for the sale of a particular cloth product to one of his customers, primarily the clothing industry or any other industry which uses cloth as part of its product. After obtaining the contract, the converter buys unfinished cloth from a greige mill and has it shipped to a finishing plant like Hanes. From the finishing plant, the goods may be shipped directly to the converter, to the converter's customers, or to another manufacturing plant for further treatment. *Id.* at 601-04, 207 S.E.2d at 731-33.

5. In 1971, approximately 95.4% of Hanes' work was done for nonresidents. *Id.* at 604, 207 S.E.2d at 733.

6. In 1971, approximately 95% of the goods shipped from Hanes were shipped outside of North Carolina. *Id.* at 605, 207 S.E.2d at 733.

7. The time from the receipt of the goods by Hanes until reshipment averaged five to six weeks but was often as little as three weeks. *Id.* at 604, 207 S.E.2d at 733.

ically located in North Carolina on "tax day," January 1,[8] and pursuant to a special statute,[9] Hanes, as custodian of the property, was compelled to list it for taxation. Hanes and its customers then contested the taxability of the goods, arguing they were only in the State "on a temporary basis" and thus were not subject to a property tax.[10] Both the county and State tax boards rejected Hanes' contention deciding that the property was within the taxing jurisdiction of the State since it was in Hanes' possession "for a very substantial business purpose—that of being dyed, finished, or otherwise processed."[11] The boards reasoned that since the property was within North Carolina's jurisdiction, it was property subject to taxation under the terms of the North Carolina Machinery Act.[12] Section 105-274 of that Act provides that all real and personal property within North Carolina's jurisdiction shall be subject to taxation unless specifically exempted or excluded.[13]

In *In re Hanes* the North Carolina Supreme Court affirmed a decision of the Superior Court of Forsyth County reversing the conclusion of the State taxing authorities. The court based its holding on section 105-304 of the Machinery Act—the section that determines

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8. North Carolina, as is common among the states, has a "tax day" on which all property within the State's jurisdiction is to be listed and appraised. *See Developments in the Law—Federal Limitations on State Taxation of Interstate Business*, 75 HARV. L. REV. 953, 978 (1962). "Tax day" in North Carolina is January 1. N.C. GEN. STAT. § 105-285 (Supp. 1974).

9. N.C. GEN. STAT. § 105-315 (1972). The statute says, "As of January 1, every person having custody of taxable tangible personal property that has been entrusted him by another for storage, sale, renting, or any other business purpose shall furnish the appropriate tax supervisor the reports required . . . ."

10. 285 N.C. at 599-600, 207 S.E.2d at 730.

11. *Id.* at 608, 207 S.E.2d at 735.

12. The present Machinery Act, N.C. GEN. STAT. §§ 105-271 to -395 (1972), was enacted by the General Assembly in 1971. Its purpose is "to provide the machinery for the listing, appraisal, and assessment of property and the levy and collection of taxes on property by counties and municipalities." *Id.* § 105-272.

13. **Property subject to taxation.**—(a) All property, real and personal, within the jurisdiction of the State shall be subject to taxation unless it is:

(1) Excluded from the tax base by a statute of statewide application enacted under the classification power accorded the General Assembly by Article V, Sec. 2(2), of the North Carolina Constitution, or

(2) Exempted from taxation by the Constitution or by a statute of statewide application enacted under the authority granted the General Assembly by Article V, Sec. 2(3), of the North Carolina Constitution.

(b) No provision of this Subchapter shall be construed to exempt from taxation any property situated in this State belonging to any foreign corporation unless the context of the provision clearly indicates a legislative intent to grant such an exemption.

Id. § 105-274.

the place in North Carolina for listing tangible personal property.[14] According to that section, tangible personal property of a nonresident corporate or individual taxpayer is to be listed where it is "situated" within the State.[15] The section defines "situated" as "more or less permanently located."[16] Relying on this definition, the court concluded that Forsyth County could not tax the goods in question because they were not "more or less permanently located in the county."[17] The practical effect of the holding was to immunize the cloth from taxation anywhere in North Carolina since only Foryth County had any connection with the property.

Significantly, *In re Hanes* virtually ignored section 105-274 of the Machinery Act,[18] the section that was the basis of the State tax board's determination. The court did not hold that the goods were beyond the State's taxing jurisdiction or that they were "exempted" or "excluded" from taxation.[19] Rather, the court looked solely to section 105-304 and its definition of "situated" to deny Forsyth County the right to tax the cloth. Therefore, from the standpoint of statutory construction, the crucial issue in *In re Hanes* was whether section 105-274—defining property subject to taxation—or section 105-304—defining the place for listing tangible personal property—was the appropriate section to determine Forsyth County's power to tax the cloth.

Section 105-274 embodies the General Assembly's determination of property subject to taxation by the local governmental units of

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14. **Place for listing tangible personal property.**—(a) Listing Instructions.—This section shall apply to all taxable tangible personal property that has a tax situs in this State and that is not required by this Subchapter to be appraised originally by the Department of Revenue. The place in this State at which such property is taxable shall be determined according to the rules prescribed in subsections (c) through (h), below. . . .

(b) Definitions.—For purposes of this section:

(1) "Situated" means more or less permanently located.

(d) Property of Taxpayers With No Fixed Residence in This State.—

(1) Tangible personal property owned by an individual nonresident of this State shall be taxable at the place in this State at which the property is situated.

(2) Tangible personal property owned by a domestic or foreign taxpayer (other than an individual person) that has no principal office in this State shall be taxable at the place in this State at which the property is situated.

Id. § 105-304.

15. *Id.* § 105-304(d)(1)-(2).

16. *Id.* § 105-304(b)(1).

17. 285 N.C. at 613, 207 S.E.2d at 739.

18. N.C. GEN. STAT. § 105-274 (1972).

19. The court said that the exemptions and exclusions mentioned in section 105-274 were "not pertinent to this appeal." 285 N.C. at 607, 207 S.E.2d at 735.

the State.[20] This determination is made under a specific provision of the State constitution that gives the General Assembly the power to classify property subject to taxation and to exempt property from taxation.[21] This power is subject to an overriding constitutional limitation expressed in article V, section 2(1): "The power of taxation shall be exercised in a just and equitable manner, for public purposes only, and shall never be surrendered, suspended or contracted away." Other specific limitations also appear in article V, section 2.[22] In addition to State constitutional limitations, the United States Constitution imposes further limitations on the General Assembly's taxing power. The federal limitations are the due process clause of the fourteenth amendment, the commerce clause of article I, section 8, and the prohibition against taxing imports of article I, section 10.[23]

The basic taxing decision of the General Assembly, as expressed in section 105-274 is that *all* property, either real or personal, is subject to taxation if it is within the State's jurisdiction and is not specifically exempted or excluded by another statute or the state constitution.[24] No distinction is made in the section between property owned by residents and property owned by nonresidents.[25] Implicit in the phrase "within the jurisdiction of the State," however, is a recognition by the General Assembly of federal constitutional limitations on the power to tax property of nonresidents.[26]

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20. H. LEWIS, THE ANNOTATED MACHINERY ACT OF 1971, at 8 (The Institute of Government, University of North Carolina, 1971). North Carolina imposes no statewide property tax. The Machinery Act merely provides the procedure for property taxation by local governments. *See* note 12 *supra*.

21. N.C. CONST. art. V, § 2.

22. The primary limitations are as follows: the power to classify or to exempt property cannot be delegated by the General Assembly; every exemption and classification shall be on a statewide basis and by a rule uniformly applicable in every taxing unit.

23. North Carolina Supreme Court decisions recognizing federal limits on state taxing power include: *In re* Asheville Citizen Times Publishing Co., 281 N.C. 210, 188 S.E.2d 310 (1972) (tax on imports); Billings Transfer Corp. v. County of Davidson, 276 N.C. 19, 170 S.E.2d 873 (1969) (due process and commerce clause); Pocomoke Guano Co. v. Biddle, 158 N.C. 212, 73 S.E. 996 (1912) (commerce clause).

24. N.C. GEN. STAT. § 105-274 (1972).

25. Subsection (b) of section 105-274 states specifically that no part of the Machinery Act "shall be construed to exempt from taxation any property situated in this State belonging to any foreign corporation unless the context of the provision clearly indicates a legislative intent to grant such an exemption."

Subsection (b) is drawn from prior N.C. GEN. STAT. § 105-396 (1965) and is included in present section 105-274 "to place together all provisions of the act dealing with the *inclusion* of property within the tax base." H. LEWIS, *supra* note 20, at 8.

26. H. LEWIS, INTRASTATE TAX SITUS OF TANGIBLE PERSONAL PROPERTY 1-3 (The Institute of Government, University of North Carolina, 1963).

Although section 105-274 makes both real and personal property subject to taxation, the mobile nature of tangible personal property creates special tax problems.[27] Personal property, unlike real property has no fixed location or situs, and in North Carolina, in which local governmental units rather than the State levy the tax on property, the intrastate tax situs of personal property is vitally important.

Historically, the North Carolina Supreme Court has relied on the General Assembly to determine where personal property, within the state's jurisdiction, is to be taxed.[28] The commitment of tax situs determination to the legislature has apparently been absolute subject only to constitutional limitations, and the court has refused to upset even inequitable taxing results.[29] In *City of Winston v. City of Salem*, the court expressed its basic thoughts on tax situs: "It seems to us that sound public policy requires that the Legislature be left free, as always heretofore, to prescribe regulations as to the *situs* of personal property, and unless the constitutional provision were plain and explicit to the contrary, we can not hold the statute to be unconstitutional."[30]

Present section 105-304 of the Machinery Act is an attempt by the General Assembly to determine the intrastate tax situs of tangible personal property whether owned by North Carolina residents or by nonresidents of the State. It provides that tangible personal property

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27. For an indication of the problems in determining tax situs of personal property see *id.*

28. *In re* Pilot Freight Carriers, Inc., 263 N.C. 345, 139 S.E.2d 633 (1965); Planters Bank & Trust Co. v. Town of Lumberton, 179 N.C. 409, 102 S.E. 629 (1920); City of Winston v. City of Salem, 131 N.C. 404, 42 S.E. 889 (1902).

29. City of Winston v. City of Salem, 131 N.C. 404, 42 S.E. 889 (1902). In that case the taxpayer corporation, a tobacco company, had its principal office and place of business (a factory) in the town of Winston but had its tobacco warehouse in the town of Salem. Salem attempted to tax leaf tobacco stored in the warehouse. Under the controlling statute, all tangible personal property was taxable at the residence of the owner, and a corporation's residence was its principal office or place of business. Thus all of the leaf tobacco was taxable in Winston despite its being stored in Salem. This result, of course, inequitably allowed a local government providing no services for the property to derive all the revenue from it, while the local government providing services derived no benefit. Nonetheless, the supreme court refused to modify the legislative determination of situs.

N.C. GEN. STAT. §§ 105-304(f)(2), (4) (Supp. 1974) attempts to avoid the result of City of Winston v. City of Salem. Although tangible personal property as a general rule is still taxable at the residence of the owner, it may acquire a situs elsewhere if "situated" there for certain business purposes. Section 105-304(f)(4) provides that the presence of tangible personal property at a business premise on "tax day" is prima facie evidence that it is "situated" at the location.

30. 131 N.C. at 405-06, 42 S.E. at 890.

of a nonresident shall be taxable where "situated."[31] Property of a resident is taxable at the owner's residence unless the property is "situated" elsewhere for certain business purposes.[32] Although the intrastate tax situs of property owned by both residents and nonresidents depends on the meaning of the word "situated," that word despite its presence in the Machinery Act since 1939 was not defined until the 1971 Machinery Act. This act defines "situated" as "more or less permanently located."[33]

The statutory definition of "situated" originated—at least in connection with the tax situs of tangible personal property—in *In re Pilot Freight Carriers, Inc.*[34] This case required the court to determine the place in North Carolina for listing certain tangible personal property owned by a resident corporation. The property in question was the rolling stock—the "line-haul" tractors and trailers—of a trucking company which had its principal office in Forsyth County but which had truck terminals in several other North Carolina locations. These "line-haul" tractors and trailers were seldom present at any one terminal for longer than loading and unloading. Under the "listing section," tangible personal property of a resident corporation was to be listed at its residence, its principal office, unless "situated" elsewhere for business purposes. The court held that all of the "line-haul" equipment was taxable in Forsyth County, the corporation's residence, because none of it had become "situated" at any one of the other terminals. The court said: "Clearly, *situated* connotes a more or less permanent location . . . . It does not mean a mere temporary presence. . . ."[35]

It is important to note that in *In re Pilot Freight Carriers, Inc.* and in subsequent cases involving the intrastate tax situs of truck rolling stock,[36] the court assumed that the property had a tax situs in the State and looked to the listing section, section 105-304, solely to determine the location within the state for taxation. In contrast to these cases, *In re Hanes* did not require the court to determine the place in

31. N.C. GEN. STAT. §§ 105-304(d)(1)-(2) (1972).
32. *Id.* § 105-304(f)(2). *See* note 29 *supra.*
33. N.C. GEN. STAT. § 105-304(b)(1) (1972).
34. 263 N.C. 345, 139 S.E.2d 633 (1965). H. LEWIS, *supra* note 20, at 89. Note that N.C. GEN. STAT. § 105-304 (1972) involves only tangible personal property.
35. 263 N.C. at 351, 139 S.E.2d at 638 (citations omitted).
36. *In re* McLean Trucking Co., 281 N.C. 375, 189 S.E.2d 194 (1972), *cert. denied* 409 U.S. 1099 (1973); *In re* McLean Trucking Co., 281 N.C. 242, 188 S.E.2d 452 (1972); *In re* Moss Trucking Co., 16 N.C. App. 261, 191 S.E.2d 919 (1972).

North Carolina where the cloth was taxable; rather, the case was a challenge to North Carolina's power to tax the property at all.

The listing section of the Machinery Act, relied on by the court to decide *In re Hanes*, specifically states that its subsections are not applicable unless the tangible personal property "has a tax situs in this State."[37] It becomes operative only after a threshold determination is made as to whether the property is "subject to taxation" by North Carolina. The primary draftsman of the North Carolina Machinery Act, Professor Henry W. Lewis,[38] describes the operation of the listing section as follows:

> Section 105-304 makes specific the fact that the section is concerned only with personal property that has a tax situs in North Carolina; it is not intended to deal with the determination of whether the property is taxable in this state. The section is concerned solely with the place within this state at which property, if taxable in this state, is to be taxed.[39]

Thus, the North Carolina Supreme Court erroneously interpreted section 105-304 in *In re Hanes*. That section is intended solely to determine the intrastate tax situs of tangible personal property which is subject to taxation somewhere in North Carolina. However, by holding that the cloth in Hanes' possession was not taxable by Forsyth County since not "situated" there, the court in effect left the goods without any "tax situs" in North Carolina. Only Forsyth County, of all the local governmental taxing units in the state, had any possible claim to tax the property.

Under a proper analysis of the problem before it, the supreme court should have looked to section 105-274 to determine if the cloth were subject to taxation in North Carolina.[40] Since the cloth was personal property and was not specifically "exempted" or "excluded"

37. N.C. GEN. STAT. § 105-304(a) (Supp. 1974).

38. Professor Lewis of the North Carolina Institute of Government was consultant and draftsman to the Local and Ad Valorem Tax Study Commission which prepared the initial House Bill 169; consultant to legislative committees and subcommittees to which the bill was referred; draftsman of the House Committee substitute; and was consultant to the floor managers of the bill. H. LEWIS, A LEGISLATIVE HISTORY OF "AN ACT TO BE KNOWN AS THE MACHINERY ACT OF 1971," at ii (The Institute of Government, University of North Carolina, 1971).

39. H. LEWIS, *supra* note 20, at 89.

40. *See* Davenport v. Ralph N. Peters & Co., 274 F. Supp. 99, 112-13 (W.D.N.C. 1966), *rev'd on other grounds*, 386 F.2d 199 (4th Cir. 1967) (construing former similar section). This case involved the taxability of cottonseed oil, owned by nonresidents, located in North Carolina storage tanks on "tax day." The court determined first that the oil was subject to taxation by North Carolina. Then it used the listing statute to determine the intrastate tax situs.

from taxation, it met the requirements of section 105-274. The only real question before the court was whether the property was within the State's jurisdiction. Hanes argued that the cloth's temporary presence was insufficient to give the State any taxing jurisdiction over it;[41] Hanes did not contend that the cloth was taxable somewhere else in North Carolina other than Forsyth County. Thus, the court should never have concerned itself with section 105-304. The section in no way addresses the jurisdictional issue.

Although the North Carolina Supreme Court erroneously used section 105-304 to determine whether the cloth possessed by Hanes was "subject to taxation" in North Carolina, a rejection of the court's interpretation of that section does not resolve the fundamental issue in the case. The holding of *In re Hanes* is that cloth, owned by nonresidents, shipped to Hanes from outside North Carolina, and then reshipped by Hanes to points outside North Carolina, is not taxable while it is in this State.[42] If these goods are not within the taxing jurisdiction of North Carolina due to federal constitutional limitations, the holding of *In re Hanes* is correct despite the errors in statutory construction.

Two of the federal constitutional limits on a state's power to tax are relevant to the facts of *In re Hanes*: the commerce clause of article I, section 8 and the due process clause of the fourteenth amendment. First, the United States Supreme Court has consistently held that the commerce clause immunizes from state taxation those commodities that are actually moving in interstate commerce.[43] However, if the interstate movement is broken or interrupted in a particular state, the Court has held that the property loses its immunity and becomes subject to local taxation.[44] Although the issue in these commerce clause cases is really a factual one[45]—whether the interstate movement is sufficiently broken to take the goods out of commerce and expose them to taxation—some controlling principles emerge in the

41. 285 N.C. at 599-600, 207 S.E.2d at 730.

42. *Id.* at 615, 207 S.E.2d at 740.

43. Minnesota v. Blasius, 290 U.S. 1 (1933); Bacon v. Illinois, 227 U.S. 504 (1913); Kelley v. Rhoads, 188 U.S. 1 (1902); Brown v. Houston, 114 U.S. 622 (1885). For a collection of the cases on this point see Annot., 171 A.L.R. 283 (1947); Annot., 78 L. Ed. 138 (1933).

44. *See* authorities cited note 43 *supra.*

45. "The questioin is always one of substance, and in each case it is necessary to consider the particular occasion or purpose of the interruption during which the tax is sought to be levied." Minnesota v. Blasius, 290 U.S. 1, 10 (1933).

decisions. If interstate transit is interrupted "due to the necessities of the journey or for the purpose of safety and convenience in the course of movement," the goods are considered to still be in interstate commerce and not subject to taxation.[46] On the other hand, if the property in interstate transit comes to rest in a state for the business purposes of the owner, or "for disposal or use" as he sees fit, then movement is considered sufficiently broken to expose the goods to state taxation.[47]

Applying these principles to *In re Hanes*, taxation of the cloth by Forsyth County would seemingly not violate the commerce clause. The cloth was not removed from an interstate shipment for any reason other than the business profit of the owners. While the cloth was located at Hanes, it was undergoing a manufacturing process, and as such, it was no longer a part of an interstate shipment,[48] but rather was "part of the general mass of property within the State."[49]

In re Hanes is closely analogous to *Bacon v. Illinois*,[50] a Supreme Court decision involving an attempt by Illinois to tax grain temporarily removed from an interstate shipment. The owner removed the grain for the limited purposes of "inspecting, weighing, cleaning, drying, sacking, grading or mixing." Once these processes were completed, the grain was put back on railroad cars and shipped to out of state buyers. In its decision, the Supreme Court determined that the interruption, although brief, was sufficient to give Illinois a right to tax the grain because removal was solely for the benefit of the owner and was unconnected with the interstate travel. It is important to note that although the taxpayer in *Bacon* was an Illinois resident, the case cannot be distinguished from *In re Hanes* on that basis. The Supreme Court expressly rejected the contention by Illinois that residency of the owner was relevant to the issue.[51] The clear indi-

46. *Id.* at 9-10; Annot., 171 A.L.R. 283 (1947).

47. Minnesota v. Blasius, 290 U.S. 1, 10 (1933); Annot., 171 A.L.R. 283 (1947).

48. Property brought from another state into a state for the purpose of subjecting the same to a manufacturing process in such state, preparatory to its being shipped to markets or customers without the state, is not deemed in transit so as to prevent acquisition by it of a taxable situs in the state where the manufacturing process takes place.

Annot., 110 A.L.R. 707, 726 (1937). An exceellent state case on this point is McCutcheon v. Board of Equalization, 87 N.J.L. 370, 94 A. 310 (Sup. Ct. 1915).

49. Minnesota v. Blasius, 290 U.S. 1, 10 (1933).

50. 227 U.S. 504 (1913).

51. "The question [immunity from taxation] is determined not by the residence of the owner but by the nature and effect of the particular state action with respect to a subject which has come under the sway of a paramount authority." *Id.* at 512.

cation of *Bacon* is that the grain was taxable by Illinois regardless of the residence of the owner.

In addition to the commerce clause, the Supreme Court has also interpreted the due process clause of the fourteenth amendment to limit state taxation of certain types of property. For example, in cases involving state attempts to tax the instrumentalities or means of commerce—barges, railroad cars, trucks, and aircraft—the limits of the due process clause have been a central issue.[52] However, for some reason, probably historical, the Supreme Court has regarded the commerce clause rather than the fourteenth amendment to be controlling in cases involving commodities in commerce.[53] The distinction in constitutional analysis between *goods* in commerce and *instrumentalities* of commerce is stated explicitly in *Braniff Airways v. Nebraska State Board of Equalization & Assessment:*

> While the question of whether a commodity en route to market is sufficiently settled in a state for the purpose of subjection to a property tax has been determined by this Court as a Commerce Clause question, the bare question whether an instrumentality of commerce has a tax situs in a state for the purpose of subjection to a property tax is one of due process.[54]

The distinction appears to be one of form rather than substance. According to a reasonable interpretation of Supreme Court decisions, once "transit [is] broken sufficiently to deprive property of the protection of the commerce clause, [the Supreme Court] has been of the opinion that *situs* was acquired so that the tax would not offend the Fourteenth Amendment."[55] That interpretation leads to the conclusion that the cloth in *In re Hanes*, clearly outside the protection of the commerce clause, had enough contact with North Carolina to meet due process challenges.[56]

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52. The instrumentalities of commerce make regular trips through several states, but are usually in no state for very long periods of time. The tax question is whether contact of the property on a regular rather than a sustained basis is sufficient to warrant an apportioned property tax. For a full discussion of the constitutional problems in taxing instrumentalities of commerce see Billings Transfer Corp. v. County of Davidson, 276 N.C. 19, 25-34, 170 S.E.2d 873, 878-84 (1969); *Developments in the Law*, 75 HARV. L. REV., *supra* note 8, at 979-87.

53. Braniff Airways, Inc. v. Nebraska State Bd. of Equalization & Assessment, 347 U.S. 590, 598-99 (1954); Powell, *Taxation of Things in Transit* (pts. 1-4), 7 VA. L. REV. 167, 245, 429, 497 (1920-1921).

54. 347 U.S. 590, 598-99 (1954).

55. Powell, *supra* note 53, at 515.

56. Even using a pure due process analysis, taxation of the cloth in *In re Hanes* appears to withstand constitutional challenge. "The test of whether a tax law violates due process is 'whether the taxing power exerted by the state bears fiscal relation to pro-

CONCLUSION

The North Carolina Supreme Court thwarted legislative intent by using section 105-304 to determine whether the cloth in Hanes' possession was subject to taxation by Forsyth County. That section was intended only to determine the intrastate tax situs of property taxable somewhere in the state. Arguably, the definition of "situated" in section 105-304(b)(1), "more or less permanently located," is somewhat misleading since personal property by its nature is seldom "more or less permanently located." However, the definition must be considered in the context of section 105-304 in its entirety. "Situated" within the section means simply "more or less permanently located" vis-à-vis any other taxing unit in the State. The word and its definition do not stand by themselves, and they do not resolve whether property is taxable in North Carolina.

If the supreme court continues to read the definition of "situated" out of context, then much of the personal property owned by non-North Carolina residents will escape taxation. For example, any goods that are part of a business inventory such as goods in the process of manufacture and goods held for sale will seldom if ever be "more or less permanently located." Therefore, if they are owned by a nonresident, under *In re Hanes* they will be immune from North Carolina taxation.[57]

If the supreme court was concerned about the federal constitutional problems it should have faced them directly, considering whether the cloth under section 105-274 was within North Carolina's jurisdiction. Although ample precedent existed to find the goods within the State's jurisdiction, a holding to the contrary would have done no vi-

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tection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return.'" Billings Transfer Corp. v. County of Davidson, 276 N.C. 19, 24-25, 170 S.E.2d 873, 878 (1969), *citing* Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444 (1940). Forsyth County provided all the protection for the goods during their stay in North Carolina. It was offering something for which it could ask return.

57. It is important to note that in *In re Hanes*, the court expressed the opinion that in two circumstances cloth owned by nonresidents would be taxable while at Hanes. In the first case, the cloth was purchased from a North Carolina mill and then shipped to Hanes for finishing. In the second case, cloth was purchased from an out-of-state mill, shipped to Hanes for finishing, but was intended to be sold to a North Carolina resident. Clearly, in both of these cases, the cloth would not be any "more or less permanently located" than in the case where the cloth is bought out of state and intended for reshipment out of state. Under the *In re Hanes* rationale this property should also be immune from taxation. 285 N.C. at 615-16, 207 S.E.2d at 740 (Higgins, J., dissenting in part).

olence to the Machinery Act. In a later case, the court could have simply held the property of a nonresident to be within North Carolina's jurisdiction, distinguishing *In re Hanes* on its facts. For some inexplicable reason, the court failed to follow this course, and instead engrafted section 105-304 onto section 105-274, thereby creating a judicial exemption for much personal property of nonresidents.

PAUL M. DENNIS, JR.

Torts—Contracts—City Streets and State Roads: New Roadblocks for Injured Plaintiffs

In *Matternes v. City of Winston-Salem*[1] the North Carolina Supreme Court held that a person injured on a city street that is part of the State highway system cannot recover from a city that was negligent in maintaining the street under a contract with the State. The ruling narrowed previous decisions of the court concerning the right of a member of the public to recover for the breach of a contract for the public benefit. *Matternes* held that a person must be an expressly intended third-party beneficiary to recover under the contract[2] and ignored the possibility of a separate tort action.

Interstate 40, a part of the State highway system, runs through the center of Winston-Salem. On January 7, 1973, an accumulation of snow and ice made an elevated portion of the road slippery. A car, driven by plaintiff's wife and containing her minor child, skidded out of control, crashed through a guard rail, and landed on the street below. The wife was killed and the child injured. Plaintiff sued in the State superior court alleging that the City of Winston-Salem was negligent in failing to remove the snow and ice and in failing to maintain the road adequately under a contract with the State.[3] Plaintiff claimed that as a member of the public he was a third-party beneficiary of the contract.[4] The superior court granted summary judgment for the city[5]

1. 286 N.C. 1, 209 S.E.2d 481 (1974).
2. *Id.* at 12, 209 S.E.2d at 487.
3. N.C. GEN. STAT. § 136-66.1(3) (1974) allows any city or town to undertake by written contract with the Board of Transportation the maintenance of State roads within municipal limits.
4. 286 N.C. at 3, 209 S.E.2d at 482.
5. *Id.* at 6, 209 S.E.2d at 483.

based upon section 160A-297(a) of the North Carolina General Statutes, which relieves North Carolina cities of the responsibility for maintenance of, and tort liability for injury on, State roads within city limits.[6]

In affirming the summary judgment, Justice Lake, writing for the North Carolina Supreme Court, did not base the decision on the statute, but stated that the liability of the city, if any, must arise from the contract between the city and the State.[7] The contract made no mention of liability for injury. The court used the Restatement of Contracts formulation of third-party beneficiaries and found that plaintiff was an incidental beneficiary possessing no rights against the promisor.[8] The intent of the parties was "that the only beneficiaries contemplated were the parties . . . themselves."[9] While all travelers would have benefited from proper performance of the contract, "such benefit [was] incidental to the real purpose of the contract . . . ."[10]

The court's holding departs from well established North Carolina precedent. In *Gorrell v. Greensboro Water Co.*[11] defendant had a contract with Greensboro to supply water. Because of the defendant's failure to supply the water, plaintiff's property was destroyed by fire. The North Carolina Supreme Court allowed plaintiff to recover as a third-party beneficiary, stating that members of the public are the intended beneficiaries of such a contract since they supply the consideration in the form of taxes.[12] In a similar situation, *Potter v. Carolina Water Co.*[13] held that, since the contracting parties could have precluded recovery by third persons, their failure to do so indicated that liability to members of the public was within the "intent of the parties."[14]

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6. "A city shall not be responsible for maintaining streets or bridges under the authority and control of the Board of Transportation, and shall not be liable for injuries . . . resulting from any failure to do so." N.C. GEN. STAT. § 160A-297(a) (1974).

7. 286 N.C. at 11, 209 S.E.2d at 486.

8. *Id.* at 12, 209 S.E.2d at 487. RESTATEMENT OF CONTRACTS § 133 (1932) divides third-party beneficiaries into three classes: donee beneficiaries, to whom the promisor intends a gift; creditor beneficiaries, to whom the promisee owes a duty; and incidental beneficiaries, who fit neither of the other two classes.

9. 286 N.C. at 15, 209 S.E.2d at 489.

10. *Id.* Justice Sharp, concurring, thought that a traveler on a road is a beneficiary of such a contract, but would not allow recovery in this case because N.C. GEN. STAT. § 160A-297(a) (1974) controls irrespective of any contract. 286 N.C. at 23, 209 S.E.2d at 489-90.

11. 124 N.C. 328, 32 S.E. 720 (1899).

12. *Id.* at 333, 32 S.E. at 721.

13. 253 N.C. 112, 116 S.E.2d 374 (1960).

14. *Id.* at 118, 116 S.E.2d at 378-79.

Matternes, attempting to distinguish *Gorrell*, stated that the *Gorrell* contract gave the water company a franchise that imposed extra duties.[15] As far as the traveling public was concerned, however, the city was in the same position as the water company—there was no one else to do the work. The public was forced to rely on the city to maintain the streets.

To support its position, *Matternes* relied heavily on *H. R. Moch Co. v. Renssalaer Water Co.*,[16] a New York case that, contrary to *Gorrell*, held that the water company was not liable to a citizen whose property was destroyed because of a failure to supply water.[17] Although the New York rule has been followed in most jurisdictions,[18] the *Gorrell* rule is favored by legal commentators.[19] The North Carolina court also stated that since Matternes had no cause of action against the State as promisee, he should not be able to sue the city as promisor.[20] This reasoning ignored *Gorrell*, in which the plaintiff likewise had no cause of action against the promisee.[21]

Since Interstate 40 is a State road, the State has a duty to maintain it.[22] Nevertheless, under the circumstances of this case, the doctrine of governmental immunity protected the State from liability for negligent failure to maintain its roads.[23] North Carolina has partially abrogated this common-law concept by the Tort Claims Act,[24] which

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15. 286 N.C. at 14, 209 S.E.2d at 488.

16. 247 N.Y. 160, 159 N.E. 896 (1928).

17. *Id.* at 164, 159 N.E. at 897.

18. Only Florida, Kentucky, and Pennsylvania follow the *Gorrell* rule. Mugge v. Tampa Water Works Co., 52 Fla. 371, 42 So. 81 (1906); Tobin v. Frankfort Water Co., 158 Ky. 348, 164 S.W. 956 (1914); Doyle v. South Pittsburgh Water Co., 414 Pa. 199, 199 A.2d 875 (1964). *See also* W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 93 (4th ed. 1971).

19. *See, e.g.*, Corbin, *Liability of Water Companies for Losses by Fire*, 19 YALE L.J. 425 (1910).

20. 286 N.C. at 14, 209 S.E.2d at 488-89.

21. *See* Mabe v. City of Winston-Salem, 190 N.C. 486, 130 S.E. 169 (1925). The court also noted that RESTATEMENT OF CONTRACTS § 145 (1932), which is the "official" policy of the Board of Transportation, would preclude recovery by Matternes. Section 145 provides that a promisor bound to a governmental body to render a service to the public is not liable for failure to do so unless there is an intent manifested in the contract to compensate members of the public or unless the promisee would be liable in the absence of a contract. Illustration 2 of this section is the *Gorrell* situation, and the Restatement writers do not follow the North Carolina rule. Thus, if *Gorrell* has any vitality left, it is limited to its particular facts.

22. N.C. GEN. STAT. § 136-66.1(1) (1974) makes the State responsible for State roads within municipal limits. *See also* Milner Hotels, Inc. v. City of Raleigh, 271 N.C. 224, 226, 155 S.E.2d 543, 545 (1967).

23. *See* W. PROSSER, *supra* note 18, § 131.

24. N.C. GEN. STAT. § 143-291 (1974) allows recovery when the injury is the "result of a negligent act of any officer, employee, involuntary servant or agent of the

makes the State liable for the negligent *acts* of its employees. Although *Matternes* characterized the city as an employee of the State,[25] the necessary "act," as construed in *Flynn v. North Carolina State Highway & Public Works Commission*,[26] was absent. In *Flynn* the State's failure to fill in a hole in a road caused plaintiff to lose control of his vehicle, but plaintiff could not recover because the failure to fill the hole was an "omission" and not an "act."[27]

In contrast, the immunity of cities extends only to "governmental" functions such as fire fighting,[28] police protection,[29] and maintaining a public library.[30] Normal tort liability attaches to "proprietary" functions, those which could be done by private contractors.[31] Maintenance of roads within city limits was early held to be a proprietary function.[32] Furthermore, section 160A-296(1) of the North Carolina General Statutes places an affirmative duty on cities to maintain streets and sidewalks.[33]

Thus, if Interstate 40 had been a city street, plaintiff could have recovered had he been able to prove the allegations in this case. Nevertheless, the court extended the State's broader immunity shield to cover a city that contracts with the State to maintain State roads. Plaintiff was foreclosed merely because the road, though maintained as a city street, was technically part of the State highway system.

The only theory considered by the majority in *Matternes* was a third-party beneficiary contract action. As suggested by Justice Huskins' dissent, most courts recognize an alternative tort theory. A promisor who undertakes a course of action must exercise reasonable care

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State while acting within the scope of his office, employment, service, agency or authority . . . ."

25. 286 N.C. at 11, 209 S.E.2d at 487.

26. 244 N.C. 617, 94 S.E.2d 571 (1956).

27. *Id.* at 620, 94 S.E.2d at 573.

28. Mabe v. City of Winston-Salem, 190 N.C. 486, 130 S.E. 169 (1925).

29. McIlhenney v. City of Wilmington, 127 N.C. 146, 37 S.E. 187 (1900).

30. Seibold v. Kinston-Lenoir County Pub. Library, 264 N.C. 360, 141 S.E.2d 519 (1965).

31. *See* W. PROSSER, *supra* note 18, § 133.

32. Meares v. Commissioners of Wilmington, 31 N.C. 73 (1848). *See also* Ferrell, *Civil Liability of North Carolina Cities and Towns for Personal Injury and Property Damage Arising from the Construction, Maintenance, and Repair of Public Streets*, 7 WAKE FOREST L. REV. 143 (1971).

33. N.C. GEN. STAT. § 160A-296(1) (1974) imposes a duty to keep streets, sidewalks, and bridges in proper repair. *See, e.g.*, Waters v. City of Roanoke Rapids, 270 N.C. 43, 153 S.E.2d 783 (1967); Mosseller v. City of Asheville, 267 N.C. 104, 147 S.E.2d 558 (1966); Faw v. Town of North Wilkesboro, 253 N.C. 406, 117 S.E.2d 14 (1960).

toward foreseeable plaintiffs.[34] While the course of conduct arises from the contract, the duty owed to third parties is one of law—the promisor cannot substitute a contractual standard of conduct for a duty of reasonable care.[35] For example, in *Jones v. Otis Elevator Co.*[36] defendant was negligent in performing a maintenance contract causing injury to a third party. The North Carolina Supreme Court held that where a dangerous instrumentality is involved or where "the act . . . is . . . dangerous to . . . others," a person not a party to the contract may sue for its breach.[37]

The water company cases[38] also support a tort action for third parties based on breach of contract. The early cases were based entirely on third-party beneficiary concepts, but in *Morton v. Washington Light & Water Co.*[39] and *Powell & Powell, Inc. v. Wake Water Co.*[40] the North Carolina Supreme Court allowed recovery under a tort theory. Finally, in *Potter v. Carolina Water Co.*,[41] the court held that a third party injured by a negligent breach of contract could sue in tort or as a third-party beneficiary of the contract.

The principal limitation on the third-party tort recovery is the requirement of misperformance rather than nonperformance.[42]

> [A] company contracting with a city to . . . supply water may fail to commence performance. Its contractual obligations are then with the city only, which may recover damages, but merely for breach of contract. There would be no tort, no negligence, in the total failure on the part of the company. . . . [B]ut if the company proceeds under its contract . . . it enters upon a public calling . . . and a neglect by it in the discharge of its obligations . . . may be regarded as breach of absolute duty. . . . The action, however, is not one for breach of contract, but for negligence, . . . and is an action for a tort.[43]

The distinction between misperformance and nonperformance is flexible and can be used to justify a result desired by the court.[44] In

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34. *See* W. PROSSER, *supra* note 18, § 92.
35. Toone v. Adams, 262 N.C. 403, 407, 137 S.E.2d 132, 135 (1964).
36. 231 N.C. 285, 56 S.E.2d 684 (1949).
37. *Id.* at 289, 56 S.E.2d at 688.
38. *See* text accompanying notes 11-21 *supra.*
39. 168 N.C. 582, 84 S.E. 1019 (1915).
40. 171 N.C. 290, 88 S.E. 426 (1916).
41. 253 N.C. 112, 116 S.E.2d 374 (1960).
42. *See* W. PROSSER, *supra* note 18, § 92.
43. Guardian Trust & Deposit Co. v. Fisher, 200 U.S. 57, 68 (1906).
44. *See* Byrd, *Recent Developments in North Carolina Tort Law*, 48 N.C.L. REV. 791, 795-96 (1970).

construing the Tort Claims Act, the North Carolina courts have interpreted the word "act" narrowly.[45] In a water company case, however, the court allowed tort recovery even where there was a "total failure to furnish water."[46] In *Council v. Dickerson's, Inc.*[47] plaintiff was injured by the negligent failure of the defendant paving contractor to provide warning lights and flags as specified in the contract with the State. Although the injury was caused by omissions, defendant was found to be involved in an "affirmative course of conduct"[48] and plaintiff was allowed to recover.

The reason *Matternes* failed to discuss the possibility of tort recovery may stem from the court's perception of the issue involved: "Can an individual user of a street . . . maintain an action against a city which contracted . . . to repair . . . and then did *nothing whatsoever* about it?"[49] The record showed, however, that the city had crews on duty and that snow and ice were removed later in the day.[50] What transpired was not a total failure to perform, but a negligent manner of performance.

The *Matternes* court had two opportunities,[51] both well supported by previous decisons, to find for the plaintiff. Under the *Gorrell* precedent, it could have held that plaintiff was a third-party beneficiary of the contract. Under the tort theory, it could have held the city liable for negligence. The court has instead overruled well established and well regarded North Carolina precedent. No policy grounds were stated, but the *Moch* decision, quoted approvingly, was based on a fear of catastrophic liability.[52] This policy does not apply here, however, since North Carolina cities have always been liable for maintaining their own streets without catastrophic results.

JAMES GALBRAITH

45. Flynn v. North Carolina State Highway & Pub. Works Comm'n, 244 N.C. 617, 94 S.E.2d 571 (1956). *See* text accompanying notes 26-27 *supra.*

46. Potter v. Carolina Water Co., 253 N.C. 112, 119, 116 S.E.2d 374, 379 (1960).

47. 233 N.C. 472, 64 S.E.2d 551 (1951).

48. *Id.* at 474-75, 64 S.E.2d at 552-53.

49. 286 N.C. at 12, 209 S.E.2d at 487 (emphasis added).

50. *Id.* at 19, 209 S.E.2d at 492 (dissenting opinion).

51. The court ignored precedent for a related but separate ground for recovery. According to dictum in Michaux v. City of Rocky Mount, 193 N.C. 550, 555, 137 S.E.2d 663 (1927), a city has a duty to warn of dangerous conditions on city streets which are part of the State highway system even if it has no duty to repair them.

52. 247 N.Y. at 168, 159 N.E. at 899.