CORPORATIONS—SECURITIES ACT OF 1933—LIABILITY FOR MISSTATEMENTS AND NONDISCLOSURES UNDER SECTION 11—*Escott v. BarChris Construction Corporation, 283 F. Supp. 643 (S.D.N.Y. 1968)*—On March 30. 1961 BarChris Construction Corporation, a New York corporation engaged since 1946 in the construction and operation of bowling alleys, filed a registration statement with the Securities and Exchange Commission for a proposed sale of 5½ per cent convertible subordinated fifteen year debentures. Amendments to the statement were filed on May 11 and May 16, and the statement became effective on the later date. On May 24, BarChris received the proceeds of the sale of the debentures, $3,302,298.65. As the bowling alley construction boom declined, BarChris found itself in increasingly poor financial condition. On October 29, 1962, it filed a petition in bankruptcy. Interest on the debentures on November 1, 1962 was not paid. On October 25, 1962, holders of the debentures brought an action under Section 11 of the Securities Act of 1933[1] against the Corporation, the signers of the registration statement, the underwriters of the bond issue, and Pete, Marwick, Mitchell, and Co., BarChris' auditor, claiming that the statement contained false statements and material omissions.

District court Judge McLean found overstatements of sales, earnings, assets, and orders backlog, understatements of contingent liabilities and failures to make adequate disclosure with regard to officers' loans, use of proceeds from the debentures, customers delinquencies and operations of bowling alleys.[2] He then held that all the statements relating to the affairs of 1961 contained material misstatements and omissions as did some from earlier years.[3]

Turning then to an examination of the "due diligence" defense of each defendant, Judge McLean found that no defendant maintained the burden necessary to show due diligence. The defense is established by a showing by the defendant:

> [A]s regards any part of the registration statement not purporting to be made on the authority of an expert . . . he had, after reasonable investigation, reasonable grounds to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . . .[4]

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[1] 15 U.S.C. §77k (1964).

[2] Escott v. BarChris Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968). A full summary of the various falsities and omissions appears in the opinion on page 679. McLean found that 1960 sales were overstated by $653,900 and 1960 net operating income by $246,605. The 1960 Balance Sheet showed a $609,689 overstatement of assets. Sales and profits for the quarter ending March 31, 1961 were overstated by $519,810 and $230,755, respectively. Contingent liabilities were understated by $375,795 as of December 31, 1960, and $618,853 as of April 30, 1961. Moreover, $325,000 of contingent liabilities as of December 31, 1960 and $314,166 as of April 30, 1961 should have been shown as direct liabilities. Failure to disclose included $386,615 of outstanding officer's loans, $1,160,000 use of proceeds not shown in the prospectus, over $1,350,000 potential liabilities due to customers' delinquencies and the fact that BarChris was already engaged and was about to become more heavily engaged in the operation of bowling alleys.

[3] The test for materiality is defined in the regulations of the Securities and Exchange Commission, 17 C.F.R. 230.405(1):

> "The term "material," when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered."

[4] 15 U.S.C. §77k(b)(3) (1964).

Each defendant was found either not to have had a reasonable belief that the registration statement was true or not to have made such a reasonable investigation so as to have a ground to believe it was true, or both. The defendants included officers involved in the daily operations of the firm, house counsel to the firm, so-called "outside" directors, the lawyer who prepared the statement (also a director), the underwriters of the issue and the auditor.

As originally enacted, the Securities Act of 1933 exacted the standard of care of a signer of a registration statement to be that of "a person occupying a fiduciary relationship."[5] The Senate suggested an even more rigid standard before the passage of the bill that became the Act — it was proposed that the directors be made insurers or guarantors of the truth or accuracy of the statement.[6] For the express purpose of clarifying and removing any uncertainties as to the standard,[7] it was changed to that of "a prudent man in the management of his own property."[8] The final standard was the same as that employed in the English Companies Act.[9]

This history of Section 11 does little to clarity the intention of Congress as to just what was to be expected of signers before they affixed their signatures to registration statements in order that they might assert due diligence if the statement proved to be false and misleading. As Judge McLean stated in his opinion, "[s]urprisingly enough, there is little or no judicial authority on this question [of what is necessary to sustain the burden of proving due diligence]."[10]

The English Companies Act, a close parallel to the Securities Act of 1933, contains the same provisions for determining the liabilities and defenses available to directors.[11] However, the English courts had evolved the standard that directors, in discharging their duties when signing registration statements, could rely on information from clerks and other such competent persons[12] but not the statements of promotors or other directors.[13] The English constructions, therefore, point to the conclusion that reliance on statements made by those who were in a position to know and understand the daily operations of the enterprise was sufficient to absolve the director of responsibility when those statements proved to be false. Eve, J. in the *Thrift* case sets forth this discussion:[14]

> Counsel for one of the defendants contended that the arguments advanced on the behalf of the plaintiff involved this consequence, that no director could discharge the onus of proving he had reasonable ground for believing a statement to be true without showing that he had separate advice from his own lawyer [and] his own accountant . . . . I do not agree. In my opinion the existance of reasonable grounds for believe in the truth of any statement is established by the proof of any facts or circumstances which would induce the belief in the mind of a reasonable man . . . who stands midway between the careless . . . man and the over-cautious and straw-splitting man . . . .

Judge McLean, on the other hand, has held that corporate directors can not

[5] 3 L. LOSS, SECURITIES REGULATIONS 1731 (2d ed. 1961) [hereinafter cited as 3 LOSS].

[6] H.R. REP. NO. 152, 73d Cong., 1st Sess. 26 (1933).

[7] H.R. REP. NO. 1838, 73d Cong., 2d Sess. 41 (1934).

[8] 15 U.S.C. §77k(c) (1964).

[9] 3 LOSS, *supra* note 5, at 1726.

[10] Escott v. BarChris Construction Corporation, 283 F. Supp. 643,683 (S.D.N.Y. 1968).

[11] 19 & 20 Geo. 5, c.23, & 37 (Halsbury 1929).

[12] Stevens v. Hoare, 20 T.L.R. 407, 409 (Ch. 1904).

[13] Adams v. Thrift, [1915] 1 Ch. 557, *aff'd* [1915] 2 Ch. 21 (Ct. App.)

[14] *Id.* at 565.

rely on the statements of corporate management to establish their due diligence defenses. Particularly is this shown in the case of Auslander, an outsider who had become a director on April 17, 1961, virtually the eve of the filing. He relied on the assurances of management that the prospectus was correct. The Judge stated:[15]

> He is presumed to know his responsibility when he becomes a director. He can escape liability only by using that reasonable care to investigate the facts which a prudent man would employ in the management of his own property.

Rose, another outside director was also found not to have established due diligence. "He believed that the registration statement was true. His only basis for his belief was his reliance upon Peat, Marwick, and upon the BarChris officers."[16]

This case, therefore, holds directors to a higher standard than the English cases. They are responsible for conducting their own investigations into primary material — they can not merely investigate by questioning management.

An examination of the aims and purposes of Section 11 and the entire Securities Act of 1933 is necessitated by the holding, in light of the seemingly strict interpretation of the language by District Judge McLean. In the midst of the economic disorganization of the Thirties, Congress enacted the Securities Act of 1933. The stock market had collapsed and securities in the hands of a myriad of investors were worthless. However, the Act was not designed as a panacea for an unstable securities atmosphere; there was nothing in the Act that could control the speculation fever that had seized the American investors in the Twenties, nor would unsound capital structures be prevented by the Act.[17] The Act was designed to require the truth about securities at the time of issue and "to impose a penalty for failure to tell the truth. Once it is told, the matter is left to the investor."[18]

> It is not the object of the Act simply to provide a legal remedy for the investor who has bought securities upon a false representation, to compensate him for a loss incurred. Even the provisions for civil liability are calculated to be largely preventive rather than redressive. . . . [E]ven this purpose of securing preventive vigilance and caution on the part of the persons concerned is only coordinate with, or probably subordinate to, another object. The Act seeks not only to secure accuracy in the information that is volunteered to investors, but also, and perhaps more especially, to compel the disclosure of significant matters which were heretofore rarely, if ever, disclosed.[19]

The effects of the Act were to be the prevention of fraudulent transactions and the placing in the market of a body of facts that would make wise investing more of an science.[20]

The civil liabilities of the Act, particularly as set forth in Section 11, represented a change from the concepts of the common law of corporations. In general the Act reaffirms the duties of certain classes of persons to be responsible for the

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[15] Escott v. BarChris Construction Corp., 283 F. Supp. 643, 688 (S.D.N.Y. 1968).

[16] *Id.* at 689.

[17] William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L. J. 171 (1933) [hereinafter cited as Douglas].

[18] *Id.*

[19] Harry Shulman, *Civil Liability and the Securities Act*, 43 YALE L. J. 227 (1933) [hereinafter cited as Shulman].

[20] Douglas, *supra* note 17, at 172.

assertions in a registration statement.[21] The Act, however, extended those duties. It denies the defense available at common law that the director was under no duty to the securities purchaser due to a lack of privity between them, other than a duty not to act so as to defraud.[22] The traditional common law concept of scienter is replaced by notions of insufficient search and unreasonable grounds for belief.[23] In another departure from the common law the Act required that the defendant bear the burden of proving the reasonableness of the search.[24] The penalties purposely were made stringent to guarantee that they would provide sufficient impetus to assure full disclosure.[25]

But despite the high purpose and noble aims of the Act, there has not been a sizeable amount of litigation under Section 11, primarily because of three factors: (1) litigation in the United States today is simply too expensive; the average investor feels that he would simply be throwing good money after bad when he is faced with the fact that, due to misleading information, a security he holds becomes worthless; (2) the discovery and proof of materially misleading or untrue statements is too difficult; and (3) the liability of the statement signers is not absolute.[26]

The shift in the burden of proof accomplished by Section 11 forced the defendants in *BarChris*[27] affirmatively to show their due diligence, rather than sitting by passively while the plaintiffs attempted to show the signers were not diligent. The advantage to a plaintiff under Section 11 is obvious.

> [T]he requisite that the defendants named in Section 11 prove *reasonable investigation, reasonable grounds for belief, and belief* is nothing more than the application of the general principle that he who has knowledge, or the means of acquiring knowledge of a particular fact should bear the burden of coming forward with the evidence after the other party has advanced his case to the proper point to require such evidence.[28]

District Judge McLean was well within the ultimate aims of Section 11 in his holding in *BarChris*.[29] The information contained in the statement was false; the philosophy and language of Section 11 require it to be true. The signers did not establish due diligence; the burden to do so is clearly theirs. District Judge McLean's opinion consists primarily of the finding of facts, rather than an extended discussion of the legal problems inherent in defining due diligence. Faced with what was, for all practical purposes, a case of first impression, he had only the statute to apply to the facts presented to him at trial. These facts were not, for the most part, such that would make out a close case; rather, they formed a picture of a corporation that was in serious trouble and desperate for funds. The result was a registration statement that contained not just a few errors but gross misstatements and omissions that provided the potential investor with a picture of that corporation

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[21] Harry A. Teass, *Duties of Directors and Others As Prescribed by Section 11 of the Securities Act of 1933*, 20 VA. L. REV. 817 (1934) [hereinafter cited as Teass].

[22] Shulman, *supra* note 19, at 252.

[23] *Id.* at 248. *See also*, Douglas, *supra* note 17, at 174.

[24] *Id.* at 249.

[25] Douglas, *supra* note 19, at 173.

[26] Shulman, *supra* note 19, at 251.

[27] Escott v. BarChris Construction Corp., 283 F. Supp, 643 (S.D.N.Y. 1968).

[28] Teass, *supra* note 21, at 844.

[29] Escott v. BarChris Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968). His decision will stand for the time being. Correspondence with the parties revealed that there will be no appeal.

which would warrant a paraphrase of the familiar fiction disclaimer: any resemblance between this statement and the corporation it is supposed to describe is purely coincidental.

Given the factual situation he was faced with, District Judge McLean was fully justified in his findings of no due diligence on the part of the officers of the corporation. Perhaps the outside directors, Rose and Auslander, were caught in a trap the existance of which was unknown to them, but they signed the statement and the law holds them liable for their actions. Their unfamiliarity with the operations of BarChris Construction might have served to put them on notice that they should go beyond the assurances of the officers before affixing their signatures. Doing so without further inquiry is evidence that they did not act as prudent men would in the management of their own property. Harsh as the opinion may seem on brief examination, when the purposes of the Act are taken into account, its necessity becomes evident.

The effect of the decision on future Section 11 cases remains to be seen. As stated above this case was made up of "bad" facts and perhaps should be limited to them. If the case serves the purpose of placing those involved on notice that Section 11 still exists and encourages better practices in the issuance of securities, it will have performed a noble task.

The question of the effect of the decision upon the institution of the outside director remains. It is the author's opinion that this aspect is of great importance to the legal profession as a whole, for while there are relatively few specialists in the filing of registration statements with the S.E.C., many attorneys are in the positions of being outside directors or counsel to outside directors.

Early commentators on the Act and Section 11 were concerned with its effects on directors, though their views were varied. (Following the initial reaction to the new law there were virtually *no* commentators on Section 11.) It was recognized on the one hand that the risks to directors were greatly increased by the Act and Section 11, and that, while some directors were merely on the board to draw prestige and fees,

> [T]here are a great many, particularly of the larger and more complicated enterprises, who do [direct] and yet are not personally familiar with all details of operation. Nor could their services be obtained in most cases if they were required to investigate details of the enterprise.[30]

A second view was that little or no effect on directors would result from the passage of the Act, and the directors would fully accept Section 11, for they would soon realize "that if they have made a 'reasonable investigation,' have 'reasonable grounds to believe' and 'believe' they will not be liable under Section 11."[31] The third view was that, while a burden would be placed on "the institution of inactive or dummy directors," the director who was active in the operation of the enterprise would realize that all that was required was "reasonable diligence in the performance of work which involves risk of loss to others," and these directors would not balk at retaining their positions under the Act.[32]

It has long been the practice of American corporations to look beyond management for the outside director.[33] The purpose of a board of directors is often

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[30] Douglas, *supra* note 17, at 195 [footnotes omitted].

[31] Teass, *supra* note 21, at 851.

[32] Shulman, *supra* note 19, at 253.

[33] M. FEUER, PERSONAL LIABILITIES OF CORPORATE OFFICERS AND DIRECTORS 11 (1961) [hereinafter cited as FEUER].

best served when it collects for the benefit of management a group of outsiders who are skilled in areas not available to management. "The presence on the board of experts skilled in allied fields can be, at times, of inestimable value."[34] A man may chose to become an outside member of a board for several reasons. He may seek to broaden his own development as an executive by applying his abilities to finding solutions in a variety of corporate situations. Association with a broader list of industrial and community leaders and enhancement of prestige may also serve as factors in his choice. The opportunity to perform a quasi-public service, meet new challenges and undergo new experiences also may prove appealing.[35]

Outside directors are rarely expected to be in a position to make decisions based on direct knowledge of business operations; rather they should provide impartial and sound balance to the board.[36] A roster of suggested sources of outside directors includes lawyers, bankers, engineers, and public relations experts.[37] Men possessed of particular points of view can be invaluable to the corporation as the needs for their opinions arise.[38]

Up until the *BarChris*[39] decision it has been "rather usual for directors to sign what-ever they're given. . . ."[40] Books directed at telling directors what their job was and how to do it have made little reference to "due diligence" in signing registration statements. Typical is "[d]irectors, among others, may be liable for offending registration statements. . . unless they establish *good faith and absence of negligence.* [Emphasis added.]"[41] The director was to provide acumen in his particular area and:

> No one proposed as a director need hesitate to assume that position because of any feeling that he is not fitted for it. So long as he makes an honest effort to do the job . . . he is reasonable sure to be free of liability. . . .[42]

The usual procedure to establish any needed due diligence defenses had often been the "due diligence meeting," held shortly prior to a final issuance of the securities, where those involved could ask questions "which they felt they should ask . . . ."[43] Nobody knew how valuable a safeguard that was.[44]

> What upsets the financial community about the BarChris decision is that some of the defendants — found careless by the judge did as much checking as many of their colleagues do in similar situations.[45]

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[34] P. JACKSON, CORPORATE MANAGEMENT § 52 at 59 (1955) [hereinafter cited as JACKSON].

[35] J. JURAN & J. LOUDEN, THE CORPORATE DIRECTOR 326 (1966). It is interesting to note that this book has no corresponding list of reasons not to join a board as an outsider.

[36] FEUER, *supra* note 33, at 22.

[37] JACKSON, *supra* note 34, at 51.

[38] *Id.* at 52.

[39] Escott v. BarChris Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).

[40] Wall Street Journal, May 14, 1968, at 1, Col. 8.

[41] M. FEUER, HANDBOOK FOR CORPORATE DIRECTORS 158 (1965). *See also,* P. JACKSON, WHAT EVERY CORPORATION DIRECTOR SHOULD KNOW 173 (1949).

[42] FEUER, *supra* note 33, at 11.

[43] C. ISRAELS & G. DUFF, JR., WHEN CORPORATIONS GO PUBLIC 155-56 (1962).

[44] 3 LOSS, *supra* note 5, at 1731. Professor Loss goes on to warn, "But it seems advisable, in the present state of the law and in view of the potentially grave liabilities under § 11, to do something of this sort in a serious manner rather than perfunctorily." His prediction, published seven years before *BarChris,* proved valid.

[45] Wall Street Journal, May 14, 1968, at 1, Col. 8.

Assuming that the outside director is a valuable asset on the board and that, in light of *BarChris*,[46] much more will be required of him in the way of personal investigation of a corporation's affairs before he signs a registration statement, he may not be so willing to offer his services in the future. "The decision will probably give directors the willies . . . ."[47] Judge McLean probably has not placed the standard so high as to frighten off all outside sources of advice and talent, but there can be no doubt that he has severely limited the field. The outside director who signs everything he is given does not belong on the board, but many capable and conscientious men may find, or be advised, that the risk is just too high to justify the prestige and other rewards that come from being a member of the board.

Ronald L. Solove

REAL ESTATE—BROKER'S COMMISSION—TIME OF ACCRUAL—*Ellsworth Dobbs, Inc. v. Johnson, 50 N.J. 528, 236 A.2d 843 (1967)*—Ellsworth Dobbs, Incorporated, a real estate broker, brought suit against John and Adelaide Johnson, sellers of the real estate, and Joseph Iarussi, the prospective purchaser thereof, in connection with the attempted sale of a farm. The Johnsons listed the property for sale with Dobbs, and Dobbs procured Iarussi as a purchaser. The Johnsons and Iarussi entered into a contract of sale, but there was no closing due to Iarussi's inability to obtain financial backing. The broker then initiated the present suit against both sellers and purchaser seeking his commission. The broker contended that the sellers had breached an express agreement to pay his commission for bringing about the contract of sale. Plaintiff also charged the purchaser with breach of an implied agreement to pay if he failed to complete the purchase and thus deprived the broker of his commission from the sellers.[1] The trial court determined that the contract between the broker and seller specified no event for the accruing of the broker's commission, and that therefore, as a matter of law, the broker earned his commission when the seller indicated his acceptance of the purchaser by executing the contract of sale.[2] The trial court then held that it was a jury question as to whether the purchaser implicitly agreed to perform in the event that plaintiff found suitable property and a contract of sale was executed.[3] The appellate court reversed the judgment against the sellers, holding that there were sufficient facts under the contract of sale to warrant submitting to the jury the question of whether the broker's right to the commission had been conditioned, by special agreement, upon the transfer of title.[4] The appellate court also reversed the judgment against the purchaser

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[46] Escott v. BarChris Construction Corp., 283 F. Supp. 643 (S.D.N.Y.) 1968).

[47] Wall Street Journal, May 14, 1968, at 1, Col. 8.

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[1] Ellsworth Dobbs, Inc. v. Johnson, 50 N.J. 528, 535, 236 A.2d 843, 846 (1967).

[2] *Id.* at 535, 236 A.2d at 846. New Jersey cases had held that, in the absence of a special agreement, an authorized broker is entitled to a commission when he produces a purchaser able and willing to buy on the seller's terms and the seller enters into a binding contract with the purchaser, even though the purchaser eventually proves to be financially unable to perform. Richard v. Falleti, 13 N.J.Super. 534, 536, 81 A.2d 17, 18 (App. Div. 1951).

[3] Ellsworth Dobbs, Inc. v. Johnson, 50 N.J. 528, 535, 236, A.2d 843, 846 (1967).

[4] Ellsworth Dobbs, Inc. v. Johnson, 92 N.J.Super. 271, 279-80, 223 A.2d 199, 203-04 (App. Div. 1966). The rule in New Jersey is such that the broker and seller may by special agreement condition the broker's right to a commission upon a future happening, such as the actual transfer of title.

on the ground that there was insufficient evidence to show either an express or an implied agreement to perform by the purchaser.[5] The Supreme Court of New Jersey reversed and established a new rule concerning the accrual of a real estate broker's commission:[6]

> . . . the broker earns his commission when (a) he produces a purchaser ready, willing and able to buy on the terms fixed by the owner, (b) the purchaser enters into a binding contract with the owner to do so, and (c) the purchaser completes the transaction by closing the title in accordance with the provisions of the contract.[7]

Unlike this new rule, which delays the accruing of the commission until the transfer of title, the old rule provided that a broker's commission accrued as soon as he produced an able and willing purchaser who entered into a contract of sale on terms authorized by seller.[8] The old rule arose from a desire of nineteenth century courts to protect brokers from unscrupulous and capricious sellers.[9] The broker-seller relationship is comparable to a situation arising out of a unilateral contract. The seller is the offeror and the broker is the offeree. An offeror's obligation under a unilateral contract is conditioned upon the completion of the requested performance by the offeree.[10] Thus a seller of real estate was not thought to be obligated to pay the broker his commission until the broker sold the land. Courts feared that at any time before the transfer of title the seller could capriciously terminate the offer and thereby destroy the broker's right to a commission even though the broker had produced an able and willing purchaser.[11]

To avoid such conduct by sellers, courts ruled that a broker earned his commission as soon as he produced an able and willing purchaser and such purchaser enters into a contract of sale on terms authorized by the seller. In cases of purchaser default, the seller had to nevertheless pay the broker his commission if the sales contract had been executed since that event shifted the risk of the purchaser's nonperformance to the seller.[12] Courts rationalized the old rule upon one of two theories. The first theory was that by executing the sales contract the seller not

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[5] *Id.* at 282-83, 223 A.2d at 205.

[6] Ellsworth Dobbs, Inc. v. Johnson, 50 N.J. 528, 236 A.2d 843 (1967).

[7] *Id.* at 551, 236 A.2d at 855.

[8] *Id.* at 543, 236 A.2d at 850-51; Richard V. Falleti, 13 N.J.Super. 534, 536, 81 A.2d 17, 18 (App. Div. 1951); Alnor Const. Co. v. Herchet, 10 N.J. 246, 253, 90 A.2d 14, 18 (1952). Courts stating this rule recognize the fact that the seller must have an opportunity to accept the purchaser. Richard v. Falleti, 13 N.J.Super. 534, 536, 81 A.2d 17, 18 (App. Div. 1951). One court has stated that the purchaser obtained need not be able and willing. Freeman v. Van Wagenen, 90 N.J.L. 358, 360, 101 A. 55, 56 (Sup. Ct. 1917).

[9] *See* Hinds v. Henry, 36 N.J.L. 328, 332 (1873) (Seller cannot arbitrarily defeat broker's right to commission after broker has produced a purchaser); Rauchwanger v. Katzin, 82 N.J.L. 339, 340-41, 82 A.510 (Sup. Ct. 1912) (Seller cannot deprive broker of the fruits of his labor); Lehrkoff v. Schwartsky, 2 N.J.Misc. 353, 354, 125 A. 496 (Super. Ct. 1924) (Court expresses doubt about seller escaping liability for commission if he capriciously refused to carry out his contingent contract). *See generally* Wallace, *Effect of Qualifying Listing Language on Real Estate Broker's Commissions; Obligation of a Listing Property Owner*, 1957 WASH. L.Q. 297 [Hereinafter cited as Wallace, *Effect of Listing Language*].

[10] Tartoria v. Manko, 134 Conn. 345, 347, 57 A.2d 493, 494 (1948).

[11] *See* Kock v. Emmerling, 63 U.S. (22 How.) 69, 74 (1859).

[12] Amies v. Wesnofske, 255 N.Y. 156, 167, 174 N.E. 436, 439-40 (1931) (Dissenting opinion — seller assumes the risk of buyer's nonperformance). *cf.* Matz v. Bessman, 1 N.J.Misc. 5, 6 (Super. Ct. 1923) (Broker does not insure the buyer). *See generally* Perrin, *What Performance Entitles a Real Estate Broker to Commission — New York Law*, 23 YALE L.J. 399, 399-444 (1914).

only expressly bound himself to sell the property but also implicitly accepted the financial condition of that purchaser.[13] This "acceptance" of the purchaser estopped the seller from asserting the purchaser's inability to perform as a defense to the broker's suit for his commission. The second theory was that the agreement between seller and broker required only that the broker negotiate a sale.[14] According to these theories the seller, in hiring a broker, does not intend to rely upon the broker's knowledge of the purchaser's financial position. The seller intends to make his own investigation of the purchaser's position before signing the sales contract.[15]

In order to clarify the broker-seller relationship with respect to real estate, two points should be made. First, it should be recognized that there is no difference in legal result between the old rule and the new rule where the seller is the defaulting party.[16] The distinction between these rules arises only when the purchaser is in default. Second, it should be understood that neither rule is applicable where, by special agreement, the parties provide otherwise.[17] Thus, under the old rule the parties could have provided by special agreement that the commission would not accrue until the transfer of title. And, under the new rule, the parties can provide that the commission accrues upon the execution of the sales contract.[18]

In many ways the old rule, as applied, was unfortunate. That rule might have been unnecessary to avoid the problem of the unscrupulous seller in the unilateral contract situation. Courts could have conditioned the broker's right to a commission upon the transfer of title, yet provided that this condition for accrual would be inapplicable (and the broker would have an immediate right to his commission) where the seller failed to perform.[19] In this way the problem of the unscrupulous seller who would unnecessarily refuse to perform could be solved without moving the accrual time for the commission up from the transfer of title to the execution of the sales contract. The old rule was also undesirable because it seems to have run counter to the actual intentions of the parties. In the broker-seller relationship, the seller normally intends to become liable to his broker for a commission only upon the sale of the land. It cannot be said that brokers are unaware of this situation. So, unless there is a special agreement to the contrary, the realistic expectation is that the commission will not accrue until there is a transfer of title.[20] The old rule, which declares generally that the commission accrues upon the execution of the sales contract, seems contrary to the above intention.

Finally, the old rule was unfortunate in its application. It purportedly required the occurrence of two events before the broker earned his commission: (1) the broker's presentation of an able and willing purchaser; and (2) the execution of

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[13] *See, e.g.*, Brindley v. Brook, 10 N.J.Misc. 612, 614, 160 A. 398 (Super. Ct. 1932).

[14] *See, e.g.*, Freeman v. Van Wagenen, 90 N.J.L. 358, 360, 101 A. 55, 56 (Sup. Ct. 1917).

[15] Ellsworth Dobbs, Inc. v. Johnson, 50 N.J. 528, 547-48, 236 A.2d 843, 853 (1967).

[16] *Id.* at 551, 236 A.2d at 855.

[17] *Id.* at 546, 236 A.2d at 852.

[18] The court in *Ellsworth* restricted the broker's ability to make a special contract by declaring unconscionable any contract containing contrary provisions concerning the accrual of the broker's commission whenever substantial inequality of bargaining power, position or advantage exist. Ellsworth Dobbs, Inc. v. Johnson, 50 N.J. 528, 555, 236 A.2d 843, 857 (1967).

[19] *See* Kock v. Emmerling, 63 U.S. 68 (1859); Riggs v. Turnbull, 105 Md. 135, 66 A.13 (1907); *But see* Coppage v. Howard, 127 Md. 512, 96 A. 642 (1916). *See generally* Note, *The Implications of a Promise to Buy or Sell into a Real Estate Brokerage Contract: An Analysis of the Ready Willing and Able Theory*, 114 U. PA. L. REV. 380, 384-85 (1966).

[20] Ellsworth Dodds, Inc. v. Johnson, 50 N.J. 528, 547, 236 A.2d 843, 852-53 (1967); Dennis Reed, Ltd. v. Goody, [1950] 1 All E.R. 919, 923 (K.B.). *See* Wallace, *Effect of Listing Language*, note 9 *supra*, at 299.

the contract of sale.[21] In reality, however, the execution of the sales contract, alone, was sufficient to give the broker a right to the commission.[22] Early courts, being concerned with defaulting sellers and not defaulting purchasers, gave minimal attention to the consequences of a broker's failure to produce a financially able purchaser. Later courts seemingly failed to recognize this oversight and held the seller liable for the commission even though the buyer was unable financially to complete the sales contract.[23] Thus any significance the word "able" had in connection with the broker's task in producing a purchaser was eliminated.[24] Sellers often found themselves at the mercy of unscrupulous brokers who could earn their commission by simply ". . . tendering a human being who is physically and mentally capable of agreeing to buy the property . . . so long as the owner enters into a sales contract with such person."[25]

The new rule announced by the court in *Ellsworth* goes far towards correcting the above deficiencies in the old rule. This new rule requires the occurrence of three events before the broker's right to his commission accrues: (1) the procurement of an able and willing purchaser; (2) the execution of a sales contract; and (3) the transfer of title. Implicit in this new rule is the fact that ". . . if the failure of completion of the contract results from the wrongful act or interference of the seller, the broker's claim is valid and must be paid."[26] Thus the problem of the unscrupulous seller who would capriciously terminate the broker-seller relationship, thereby destroying the broker's right to a commission, is avoided. The third requirement in the new — that there be a transfer of title — conforms to the intentions and realistic expectations of the parties. To repeat again, the broker expects to produce a purchaser capable of completing the sales contract and thereby receive his commission.[27] The seller intends to accept the purchaser produced without an inquiry into his financial status and to pay the broker's commission from the tendered purchase price.[28] Therefore, the seller should not be barred from asserting the purchaser's inability to perform as a complete defense to a broker's suit for his commission.[29] This approach is realistic and ". . . should not be complicated by controversies over who knew what with respect to the buyer's financial capacity to close the title."[30] Finally, the new rule forces the broker to produce an able buyer and thereby assures to a seller acting in good faith the receipt of his bargain — a transferred title. Thus the court has declared the risk of purchaser inability to be a normal incident of the brokerage business.[31]

After announcing this new and realistic rule, the court in *Ellsworth* went further

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[21] The requirement that the purchaser presented be "able" was seemingly included in the old rule to protect a seller from a broker who himself might turn out to be unscrupulous. Leschziner v. Bauman, 83 N.J.L. 743, 746, 85 A. 205, 206 (Ct. Err. & App. 1912) (Essential element of the rule in *Hinds v. Henry* was the purchaser's ability to complete the contract).

[22] Ellsworth Dobbs, Inc. v. Johnson, 50 N.J. 528, 547-48, 236 A.2d 843, 853 (1967).

[23] *Compare,* Hinds v. Henry, 36 N.J.L. 328 (Sup. Ct. 1873); *and* McGavock v. Woodlief, 61 U.S. (20 How.) 221 (1857) *with* Courter v. Lydecker, 71 N.J.L. 511, 58 A. 1093 (Sup. Ct. 1904); Matz v. Bessman, 1 N.J.Misc. 5 (Super Ct. 1923); Richard v. Falleti, 13 N.J.Super. 534, 81 A.2d 17 App. Div. (1951) *and* Kock v. Emmerling, 63 U.S. 64 (1859).

[24] Ellsworth Dobbs, Inc. v. Johnson, 50 N.J. 528, 547-48, 236 A.2d 843, 853 (1967).

[25] *Id.*

[26] Id. at 551, 236 A.2d at 855.

[27] *Id.* at 551-52, 236 A.2d at 855.

[28] *Id.* at 547, 236 A.2d at 852.

[29] *Id.* at 551-52, 236 A.2d at 855.

[30] *Id.* at 552, 236 A.2d at 855.

[31] *Id.*

and declared that the broker here has a right of action for his commission against the defaulting purchaser.[32] This right of action is based upon the conclusion that a purchaser who solicits a broker to find property for him implicitly promises that if the broker finds suitable property and he executes a sales contract with the seller, he will perform that contract.[33] His failure to do so makes him liable to the broker for the amount of the commission.

It is axiomatic that a century of precedent should not be overturned unless the need to do so is abundantly clear. The court in *Ellsworth* has not violated this principle. The new rule, when coupled with the right of action given to the broker against purchasers in cases of purchaser default, will do much to clarify and rationalize the broker-seller relationship in real estate transactions.

Joseph J. Cox

NEGOTIABLE INSTRUMENTS—HOLDERS IN DUE COURSE—*American Plan Corp. v. Woods, 16 Ohio App.2d 1, 240 N.E.2d 886 (1968)*—A finance company, transferee, was held not to be a holder in due course of a negotiable note given in the sale of consumer goods under a conditional sales contract where the financer participated in business transactions with the dealer and had pervasive knowledge of the terms on which the sale was made.

In 1962 Crystal Clear, Inc., offered to enter into an arrangement for discounting notes, which it expected to receive from purchasers of water softeners, with the American Plan Corporation. After a complete investigation of the dealer, the members of the corporation, the type of merchandise being sold, the schedule of payments, and approximate price of the merchandise American Plan agreed to the arrangement.[1] Thereafter, it supplied the dealer with blank notes and security agreements, but it reserved the right to refuse any notes which it felt were too risky after it had made an investigation of the purchaser's credit. American Plan Corporation accepted an assignment, without recourse, of the note in question two working days after it was executed.

The uncontradicted testimony of the defendant Woods, a Negro lady with little business experience, revealed that she had been the victim of a "hard sell." She was told by the dealer, who at the time of the trial had "fled the realm," that she was not buying anything. He said the water softener was being offered to her as advertising, and that she would be paid 50 dollars for each purchaser she produced for the dealer. In fact, the 100 dollars she did pay to American Plan was from the money she had received from the dealer for leads she had given him.

Relying principally upon the authority of *Unico v. Owens*,[2] the court held that the American Plan Corporation, because of its close participation with the dealer, was not a holder in due course under Section 1303.31 of the Ohio Revised Code [U.C.C. 3-302]. In the *Unico* case, a partnership, formed expressly to finance a dealer, Universal Stereo Corporation, was denied the status of a holder in due course

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[32] *Id.* at 558-62, 236 A.2d at 859-61; Tanner Associates, Inc. v. Ciraldo, 33 N.J. 51, 161 A.2d 725 (1960).

[33] Ellsworth Dobbs, Inc. v. Johnson, 50 N.J. 528, 558-62, 236 A.2d 843, 859-61 (1967).

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[1] Brief for Appellant at 3, American Plan Corp. v. Woods, *motion to certify docketed*, No. 68-680, Ohio Supreme Court, December 9, 1968; motion overruled, May 21, 1969.

[2] 50 N.J. 101, 232, A.2d 405 (1967).

of a negotiable note taken by Universal in connection with a sale made under an unconscionable retail installment sales contract. The court noted that under an elaborate financing agreement, ". . . Unico not only had a thorough knowledge of the nature and method of operation of Universal's business, but also exercised extensive control over it."[3]

The development of the doctrine that a finance company may be denied the status of a holder in due course because of its close participation with a dealer, either in the course of business or in a particular transaction, is said to have begun with *Commercial Credit Co.* v. *Childs*,[4] decided in 1940. That case held that a finance company which took assignment on the day of execution of a note and an attached conditional sales contract, which it supplied to the retailer and on which there was a printed assignment, was not a holder in due course. The water softener was installed, but it proved defective within one month.

The basic rationale of the close participation doctrine was stated in *Buffalo Industrial Bank* v. *DeMarzio*.[5] The court pointed out that the nation had passed, "almost overnight," from a situation in which the ordinary retail purchaser received credit on his personal, unsecured promise to pay to a situation in which the conditional sales contract was the ordinary purchaser's normal, if not exclusive, means of securing credit.[6] The court noted that in many instances finance companies which, in fact, controlled a dealer's installment sales terms, were functioning as de facto credit departments of the dealer's business. Since they were in effect engaging in one business, the court held that the financer should not be allowed to hide behind the protective concept of holder in due course which had been developed in the ancient law merchant for entirely different purposes.[7]

Although *Commercial Credit Co.* v. *Childs*[8] is considered the landmark case, two other courts reached the same result under similar facts that same year.[9] The next year the U. S. Court of Appeals for the District of Columbia, citing both of those cases, held that a finance company which regularly discounted notes executed on forms supplied by it and which included printed special endorsements to it was not a holder in due course.[10]

Similar results have been reached in a number of later cases where the facts have indicated close participation by the finance company in the business operations of the dealer. Thus, where, in addition to supplying the dealer with blank forms which include a printed assignment to it, the finance company supplies schedules for calculating charges and instructions on how to complete the forms,[11] or it investigates the customers' credit before the sale[12] it has been held not to be a holder in due course. The same result has also been reached in cases in which the financer

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[3] *Id.* at 115, 232 A.2d at 413.

[4] 199 Ark. 1073, 137 S.W.2d 260 (1940).

[5] 162 Misc. 742, 296 N.Y.S. 783 (City Ct. of Buffalo 1937), *rev'd on other grounds*, 6 N.Y.S.2d 568 (Sup. Ct. 1937).

[6] *Id.* at 743-4, 296 N.Y.S. at 785. *See* Curran, *Legislative Controls as a Response to Consumer Credit Frauds*, 8 B.C. IND. & COM. L. REV. 409 (1967).

[7] *See* Jones, *Finance Companies as Holders in Due Course of Consumer Paper*, 1958 WASH. U. L. Q. 177.

[8] 199 Ark. 1073, 137 S.W.2d 260 (1940).

[9] U. S. v. Schaeffer, 33 F. Supp. 547 (D. Md. 1940). C.I.T. Co. v. Emmons, 197 So. 662 (La. App. 1940).

[10] Palmer v. Associates Discount Corp., 124 F.2d 225 (D.C. Cir. 1941).

[11] C.I.T. Co. v. Emmons, 197 So. 662 (La. App. 1940).

[12] Mutual Finance Co. v. Martin, 63 So. 2d 649 (Fla. 1953); Industrial Credit Co. v. Mike Bradford & Co., 177 So. 2d 878 (Fla. App. 1965).

was found to have directed[13] or to have been the moving force[14] behind the transaction.

Although no Ohio court had previously accepted the close participation doctrine in full, it had been partially accepted in *Davis* v. *Commercial Credit Corp.*[15] In that case the financer supplied the dealer with blank forms including printed endorsements and regularly discounted his paper. The court held that the financer had knowledge of the dealers defective work, fraudulent representations, and general methods of operation because it knew of previous complaints from the dealer's other customers. The court found that the financer, with this knowledge, conspired with the dealer to take his paper and collect its full face, on the theory that the financer was a holder in due course.[16]

The *Davis* case, like most of the cases discussed above, was decided under the Uniform Negotiable Instruments Law (N.I.L.). Today, under the Uniform Commercial Code (U.C.C.), the definition of notice as "reason to know" (on the basis of the facts actually known) may make reaching this result easier than it was under the N.I.L.[17] The court gave no indication whether this change in the law was important to its decision. *Unico*, on which the court so heavily relied, was decided under the N.I.L. But in that case, the court clearly stated it would reach the same result under either statute.

This failure to discuss the significance of the change in the law is important since the court also failed to delineate the particular facts which lead it to find close participation. The fact that American Plan Corporation investigated Crystal Clear and took its "say so" on which notes to discount indicates a degree of close participation.[18] The relationship however, was not as pervasive as it was in *Unico* and some of the other close participation cases. It is impossible, therefore, to determine whether the same result would have been reached under the N.I.L. Thus it is uncertain as to whether or not the court believed that the extention of the doctrine was made possible by the change from the N.I.L. to the U.C.C.

Not all courts and jurisdictions which have had the opportunity[19] have accepted the close participation doctrine. In Louisiana, the broad rule stated in *C.I.T. Co.* v. *Emmons*[20] has been subsequently narrowed but not overruled.[21] Several courts have held that facts such as supplying blank forms and printed assignments, taking immediate assignment after execution, and prior discounting of other notes for the

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[13] Citizens Loan Corp. v. Robbins, 40 So. 2d 503 (La. App. 1949); International Finance Corp. v. Hieger, 272 Minn. 192, 137 N.W.2d 172 (1965).

[14] Commercial Credit Corp. v. Orange County Mach. Wks., 34 Cal. 2d 766, 214 P.2d 819 (1950).

[15] 87 Ohio App. 311, 94 N.E.2d 710 (1950).

[16] *Id.* at 319, 94 N.E.2d at 714.

[17] *See U.C.C.* §§ 3-302, 1-201(19), 1-201(25)(c); *see also* Clovis, *The Low Income Buyer: The Poor Consumer as the Maker of a Negotiable Note*, in Ohio State Legal Services Association, COURSE ON LAW AND POVERTY, (1966) ¶ 1.57.

[18] American Plan Corp. v. Georgia Woods, Civil Division, No. 167714, The Mun. Ct. of Columbus, Ohio; Sept. 9, 1965, at 6.

[19] *See* Jones, *Finance Companies as Holders in Due Course of Consumer Paper*, 1958 WASH. U. L. Q. 177. The appendix summarizes most of the cases with fact patterns which might have brought them within the doctrine, even if the doctrine were not discussed or expressly considered in the case. *See also* Annot., 44 A.L.R.2d 8, especially §§ 20-24.

[20] 197 So. 662 (La. App. 1940).

[21] White System, Inc. v. Hall, 219 La. 440, 53 So. 2d 227 (1951).

dealer are not enough, standing alone, to indicate the close participation needed to negative the financer's status as a holder in due course.[22]

One reason frequently given by courts rejecting the close participation doctrine is that,

> A very considerable segment of our economy is dependent for its continued prosperity upon such free flow of credit and anything which delays or impedes such process may well be regarded as against the public interest.[23]

This argument, however, is refuted by the continued commercial health of the various jurisdictions in which the doctrine has been applied.

More particular and fundamental objections have been raised, however.[24] The most significant of these, from the point of view of the close participation doctrine, is that the very indicia being used as evidence of close participation are really evidence of good business practice in a competitive market.[25] The finance companies, it is argued, rather than controlling the dealers whose paper they regularly discount are vigorously competing with each other for the dealers business.[26] The services which they supply to the dealer, such as blank forms with printed assignments and quick discounting of all or most of the dealers paper, do not reveal either knowledge of nor control over the dealers' methods. Rather they reveal the extent to which finance companies must go to retain dealers as customers of their discounting service.[27]

The law of negotiable instruments developed at a time when commerce was expanding rapidly. Merchants were unable, due to the rudimentary communications systems of the times, to investigate each other. They therefore relied solely on the form of instruments for protection. This is no longer true. Likewise the holder in due course doctrine developed in response to a situation where instruments were transferred many times. The holder in due course doctrine facilitated this free flow of commercial instruments. In a situation where there is close participation between financer and retailer, form is not important. Neither is the policy of promoting the free flow of negotiable instruments relevant since only one transfer is made. Consequently, the concept of holder in due course, arguably at least, should not apply to the close participation situation.[28]

It is also argued that application of the close participation doctrine increases the risk of uncollectibility upon the finance companies. This, it is asserted, creates undesirable uncertainty in the market for consumer paper; this, in turn, allegedly de-

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[22] U. S. v. Tholen 186 F. Supp. 346 (N. D. Iowa 1960); Public Loan Corp. v. Terrell, 224 Ark. 616, 275 S.W.2d 435 (1955); Mann v. Leasko 4 Cal. Rptr. 124 (Dist. Ct. App. 1960); Wilson v. Gorden, 91 A.2d 329 (D. C. Cir. 1952); Allied Bldg. Credits, Inc. v. Mathewson 335 Mich. 270, 55 N.W.2d 826 (1952); Implement Credit Corp. v. Elsinger, 66 N.W.2d 657 (Wis. 1954).

[23] Implement Credit Corp. v. Elsinger, 66 N.W.2d 657, 666 (Wis. 1954).

[24] *See* Kripke, *Chattel Paper as a Negotiable Speciality under the Uniform Commercial Code*, 59 YALE L. J. 1209 (1950) [Hereinafter cited as, Kripke, *Chattel Paper*]; Shuchman, *Consumer Credit by Adhesion Contracts*, 35 TEMPLE L. Q. 125, (1962).

[25] Shuchman, *Consumer Credit by Adhesion Contract II*, 35 TEMPLE L. Q. 281, 286 (1962).

[26] *See* Kripke, *Consumer Credit Regulation: A Creditor-Oriented Viewpoint*, 68 COLUM. L. REV. 445 (1968) (Hereinafter cited as Kripke, *Consumer Regulation.*).

[27] *Id.*

[28] *See* Jones, *Finance Companies as Holders in Due Course of Consumer Paper*, 1958 WASH. U. L. Q. 177; B. CURRAN, *Legislative Controls as a Response to Consumer Credit Frauds*, 8 B.C. IND. & COM. L. REV. 409 (1967).

prives dealers of needed liquidity and raises the price of consumer credit.[29] Not only is this problem considerably overrated,[30] but it misses the point. First of all, since the finance company has both the means and ability to investigate the financial stability of dealers, they, rather than the ignorant and incapable consumer, should assume this risk.[31] If this means that dealers must depend upon their reputation for honesty and their financial stability for their liquidity, so much the better. Even if this would make it difficult for honest but economically marginal dealers to exist, why should this small group be protected at the expense of a large number of unwary installment buyers?[32] Another factor to consider is the regard which a significant section of the community will hold for our law and our economic system after they have been forced, because they can not assert any defenses, to pay for defective purchases. If the application of the doctrine would result in finance companies getting stuck, occasionally, with uncollectible notes because the maker had an adequate defense against the dealer, the finance companies could easily calculate the statistical frequency and magnitude of such losses and set up reserves.[33]

If the doctrine would have the effect of raising the cost of consumer credit, it would to the same degree effect a "pooling" of the risk among the users of consumer credit.[34] This credit would, therefore, be more expensive only to those who would never have been the victim of a "bad deal."

The close participation doctrine has not been the only judicial response to the problem created by the tremendous increase in retail installment selling. Waiver-of-defense clauses, included in most of the conditional sales contracts and which the consumer normally signs in addition to the negotiable note, have met with a judicial response similar to that given to holders in due course of negotiable instruments.[35] There has also been a considerable legislative response. Many states have enacted retail installment sales acts which deal with all or part of the problem in various ways.[36] In addition to the state legislative response a uniform solution was proposed in the early drafts of the U.C.C.

As originally conceived, the U.C.C. would have taken three steps toward meeting the problem.[37] First, it would have allowed a consumer to assert any defenses available under the conditional sales contract against a holder in due course of the note who asserted rights against the collateral. Second, it would have required that financers observe reasonable commercial standards as a condition to being a holder in due course. Third, it would have rendered waiver-of-defense clauses unenforceable. Unfortunately, these controversial provisions were dropped in order not to jeopardize acceptance of the Code.[38] The cudgal has, however, been taken up

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[29] Kripke, *Chattel Paper*, at 1214-1222.

[30] *Id.* at 1215.

[31] Note, *Consumer Sales Financing: Placing the Risk of Defective Goods*, 102 U. PA. L. REV. 782 (1954).

[32] *Id.* at 796.

[33] Kripke, *Consumer Regulation*, at 470.

[34] Kripke, *Chattel Paper*, at 1222.

[35] *See* Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L. J. 1057, 1093-1102 (1954).

[36] *See* B. CURRAN, *Legislative Controls as a Response to Consumer-Credit Problems*, 8 B.C. IND. & COM. L. REV. 409 (1967); Murphy, *Another Assault Upon the Citadel: Limiting the Use of Negotiable Notes and Waiver of Defense Clauses in Consumer Sales*, 29 O.S. L.J. 667 (1968).

[37] *Id.* at 678.

[38] *Id.* at 679.

again by the National Council of Commissioners on Uniform State Law in their proposed draft of the Uniform Consumer Credit Code (U3C). As proposed, the U3C would severely limit the use of negotiable instruments and waiver-of-defense clauses in retail installment selling.[39]

In connection with the proposed U3C it should be noted that Professor Kripke,[40] a long time opponent of legislative or judicial action in the retail installment sales area, has recently repudiated his former position.[41] Though he continues to regard the close participation doctrine and similar judicial responses as based upon a misunderstanding of the significance of the indicia used to find close participation, he now approves the U3C position. In reaching this new position he said,

> The clinching argument is the contrast between the legal relationship in consumer financing and the legal relationship in the financing of commercial accounts receivable. In that field the financial institutions, many of which are also engaged in the consumer field, have never sought to extend to the commercial field their assertion that they are entitled to freedom from customer defenses. There is one reason for this: the commercial buyers would not stand for it, for the purchase contracts are not *contracts of adhesion*.[42] What then happens to the question of freedom from defenses in the commercial field? The financer as a part of its credit determination studies the experience of the seller in respect to customer complaints and returned goods, and if the percentage is too high, refuses to do business with that merchant. The same type of thinking would provide the answer in the consumer field.[43] [Emphasis added].

A uniform, coherent legislative solution is, of course, the best answer to the problem. Until that is achieved, however, courts must work with the concepts and doctrines available to achieve a just result. In this case, the court did just that. By taking the small steps available to them, courts can make it easier for the legislature to achieve a more complete solution, for it is often easier to codify existing law than to make new law.

Joel T. Thomas

CONTRACTS—PASSENGER CONTRACTS—STATUTE OF LIMITATIONS PROVISIONS ON STEAMSHIP TICKETS—*Silvestri v. Italia Societa Per Azioni Di Navigazione, 388 F.2d 11 (2d Cir. 1968)*—On June 20, 1966, Ciro Silvestri filed a libel action in the District Court for the Southern District of New York to recover damages for an injury sustained on October 9, 1964 as a result of a lurch by defendant's ship on which he was a passenger. The Italian Line moved for summary judgment because of Silvestri's failure to comply with Article 30 of the Terms and Conditions of his ticket. That section stipulated that, in order to maintain a claim against the company, a passenger must commence his action within one year from the date of in-

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[39] *Id.* at 680-1.

[40] Professor Kripke stated in a footnote to his article in 68 COLUM. L. REV. 445, that he was associated for 20 years with the consumer finance industry, in companies with important consumer finance departments, as staff consel and as an officer.

[41] Kripke, *Consumer Regulation*, at 471.

[42] Philip Shuchman, "Consumer Credit by Adhesion Contract II," 35 TEMPLE L. Q. 281 (1962).

[43] Kripke, *Consumer Regulation* at 2.

jury.[1] It was shown by affidavit supporting the motion that Silvestri had the ticket in his possession at least three days before boarding the ship, that he had looked at it prior to embarking, and that he had consulted a lawyer in Italy. The District Court granted the motion for summary judgment for failure to begin the action within one year, a contractual period of limitation sanctioned by 46 U.S.C. § 183 (a).[2] However, the Court of Appeals for the Second Circuit reversed, holding that a steamship passenger's ticket must give reasonable notice that the terms and conditions printed on the leaves of the coupon retained by the passenger ". . . were important matters of contract affecting his legal rights."[3]

In so holding the appellate court seems to have moved toward the English method of deciding whether or not the conditions printed on a steamship passenger's ticket are binding on the passenger. In the past, American courts have tried to follow the rule laid down by the United States Supreme Court in *The Majestic*.[4] *The Majestic* held that conditions on the back of a ticket which limited liability must either be referred to in the body of the ticket contract or must be brought to the actual notice of the passenger. Since it would be virtually impossible for steamship companies to insure that the conditions have been brought to the actual knowledge of each passenger, the companies have, of necessity, resorted to various other ways of ensuring that the conditions are incorporated into the contract for passage. The courts have struggled with the question as to whether or not the companies have succeeded.

In legal theory, when an offeree accepts a paper purporting to be a contract, this acceptance implies assent to the terms and conditions printed on that paper whether or not he has actual knowledge of them. Acceptance may be indicated by an act. Accordingly, a steamship passenger's purchase and receipt of a ticket which sufficiently purports to be a contract is also acceptance of all the terms and conditions printed on that ticket (unless they are against public policy or void for some other reason). Whether this legal theory applies to a particular case in which a passenger accepts a steamship ticket has, in the past, depended a great deal on the form of the ticket. *The Majestic* held that the terms and conditions could be binding contractual provisions if they were incorporated into the ticket proper (i.e. that part of the ticket showing that the passenger is entitled to passage on a certain ship at a certain time).

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[1] ARTICLE 30 — LIMITATION OF ACTION AGAINST THE COMPANY — No action or proceeding against the Company for death or injury of any kind to the passenger shall be instituted, unless written notice is given to the Company or its duly authorized Agent within six months from the day when the death or injury occured and the action or suit arising therefrom is commenced within one year from the date when the death or injury occured. No action or suit against the Company for loss or damage to baggage or for detention of the passenger or delay in landing or any other cause shall be instituted by the passenger unless written notice of the claim with full particulers be delivered to the Company or its duly authorized Agent at the port of debarkation within ten days from the date of landing, and such action or suit is commenced within six months after the termination of the voyage.

[2] This section provides that:

It shall be unlawful for the manager, agent, master, or owner of any sea-going vessel (other than tugs, barges, fishing vessels and their tenders) transporting passengers or merchandise or property from or between ports of the United States and foreign ports to provide by rule, contract, regulation, or otherwise a shorter period for giving notice of, or filing claims for loss of life or bodily injury, than six months, and for the institution of suits on such claims, than one year, such period of institution of suits to be computed from the day when the death or injury occured.

[3] 388 F.2d 11, 17 (2d Cir. 1968).

[4] 166 U.S. 375 (1897).

However, the opinion set forth no standards for deciding the necessary requirements for establishing that the terms and conditions were so incorporated.

American courts did not readily accept the idea that the conditions on a ticket could be incorporated into the ticket proper, although it must be taken into account that the form of the tickets in question did not easily lend itself to a holding for incorporation.[5] In *La Bourgogne*,[6] where the conditions were printed on the back of the ticket and no one on behalf of the company drew the passenger's attention to them, the court held the conditions had not been incorporated. In *The Minnetonka*,[7] the conditions again were on the back of the ticket, the only difference being that they were under a heading in large type: "Notice to Passengers." Furthermore, the conditions themselves were printed in double columns of very small type, and so compactly "as to be almost illegible to one whose sight was at all imperfect."[8] In *Smith v. North German Lloyd S.S. Co.*,[9] the court was "unable to distinguish the case from *The Majestic* (citations omitted) except that the notice is printed on the front, instead of the back, of the ticket."[10]

However, in 1891, a Massachusetts Supreme Court case, *Fonseca v. Cunard S.S. Co.*[11] had held for incorporation and it was to have an impact. In that case the steamship company had provided a different form of ticket for the court to consider. The *Fonseca* ticket was entitled "Passenger Contract Ticket" and contained terms and conditions bearing the signature of the agent of the company, with a blank space for that of the passenger. Some of the conditions were printed on the face of the ticket and those on the back were referred to on the face. Although the passenger neither read the conditions nor signed them, the court held that they were enforceable. Distinguishing cases where the ticket was held to be a mere check or token showing the distance the passenger was entitled to be carried, in which case the conditions are not binding unless the passenger has read them, the court stated that the test should be whether the ticket was such that the passenger receiving it could ascertain at a glance that it was a contract containing stipulations which would determine the rights of the parties. With the ticket in *Fonseca* the court held that one could easily see it was a contract.

In *Murray v. Cunard S.S. Co.*,[12] Justice Cardozo adopted the approach of *Fonseca* and cases ruling for incorporation in other jurisdictions and introduced a new line of authority.[13] The *Murray* ticket was headed in large type: "Cabin Passage Contract Ticket"; it provided in large type that "this contract ticket is issued by the company and accepted by the passenger on the following terms and conditions." At the top of the ticket was the notice that: "The attention of passengers is specially directed to the terms and conditions of this contract." In enforcing a condition requiring written notice of a possible claim within forty days, Cardozo stated as follows:

> This is not a case of a mere notice on the back of a ticket, separate either

[5] This discussion will center on the decisions of the Second Circuit, but the problems involved are representative of those encountered in other jurisdictions.

[6] 144 F. 781 (2d Cir. 1906).

[7] 146 F. 509 (2d Cir. 1906).

[8] *Id.* at 512.

[9] 151 F. 222 (2d Cir. 1907).

[10] *Id.*

[11] 153 Mass. 553, 27 N.E. 665 (1891).

[12] 235 N. Y. 162, 139 N. E. 226 (1923).

[13] *Id.* at 166, 139 N.E. at 288.

> in substance or in form from the body of the contract [as in *The Majestic*]. Here the condition is wrought into the issue, the two inseparably integrated. This ticket, to the most casual observer, is as plainly a contract, burdened with all kinds of conditions, as if it were a bill of lading or a policy of insurance . . . . In such circumstances, the act of acceptance gives rise to an implication of assent . . . . The passenger who omits to read takes the risks of omission.[14]

Despite the *Murray* opinion, the decisions continued to rule against incorporation by distinguishing *Murray* and, in effect, limiting *Murray* to its particular facts. In *Baer v. North German Lloyd*,[15] the ticket involved had the usually filled-in section (the contract proper or "box") giving the date of sailing, the name of the ship, the signature of the steamship company's agent, and in general showing that the passenger was entitled to passage. Below this section was a heading which referred to the terms and conditions. The court held that because the conditions had not been referred to in the ticket proper they were not "wrought into the issue." In *Maibrunn v. Hamburg-American S.S. Co.*[16] a notice directing the passenger's attention to the conditions on the back of the ticket was printed on the side of the contract proper (the filled-in section). The court again held that this notice did not make the conditions binding — only the contract proper, which the court defined as those words signed by the steamship company's agent, could be binding on the passenger. *The Kungsholm*[17] was a case in which the steamship company had devised a ticket whereby the filled-in section was on the upper left hand side. The right hand side was entitled "Cruise Contract" and stated in large type "The following stipulations are a part of this contract which must be signed by the passenger on the overpage immediately upon its receipt." In refusing to enforce this notification the court followed *Maibrunn* and based its discussion on the place of the company's signature. With regard to this ticket the court stated that ". . . there [was] nothing above the carrier's signature to incorporate expressly or by reference any of these stipulations . . . ."[18]

Finally, in *Baron v. Compagnie Generale Transatlantique*[19] the Second Circuit did rule that a steamship ticket successfully incorporated the conditions printed on the ticket. First, the ticket was entitled "Passage Contract. Subject to the Terms Stated on This Page and Overpage." Below this was a filled-in section, which was followed by a notice in red type that "Passengers should read the terms of the contract of carriage stated below and overpage, their particular attention being called to the limitations of liability therein contained." Following this was the heading "Terms of Contract — Read Before Accepting." At the foot of these terms was the signature of the company's agent. The court held that these terms were unmistakably incorporated into the contract of passage: "Everything printed on the ticket rebuts the contention that the contract of carriage was restricted to the blocked-space for names, dates, and fares."[20]

Foster v. Cunard White Star Ltd.[21] did away with the place of signature distinction relied on in *Maibrunn*, *The Kungsholm*, and *Baron* by reading the terms

[14] *Id.*
[15] 69 F.2d 88 (2d Cir. 1934).
[16] 77 F.2d 304 (2d Cir. 1935).
[17] 86 F.2d 703 (2d Cir. 1936).
[18] *Id.* at 704.
[19] 108 F.2d 21 (2d Cir. 1939).
[20] *Id.* at 23.
[21] 121 F.2d 12 (2d Cir. 1941).

back into the box so that they preceeded the carrier's signature, provided that there was "a direct reference in the box on the face of the ticket to the terms and conditions of the contract . . . ."[22] The *Foster* court held that the "box" which contained a notice in the upper part in bold face type directing the passenger's attention to the terms and conditions which were on the side of that "box" did incorporate those conditions. And in *Geller v. Holland America Line*[23] the court held that:

> [I]t is the settled law in this circuit that passengers will be bound by such a provision [a time limitation] in the contract of carriage, if the provision is incorporated, at least by reference, in the body of the contract.[24]

However, in *Silvestri* the court has stated that:

> [T]he thread that runs implicitly through the cases sustaining incorporation is that the steamship line had done all it reasonably could to warn the passengers that the terms and conditions were important matters of contract affecting his legal rights.[25]

In determining that the *Silvestri* ticket did not incorporate the time limitation stated therein, the court compared this ticket with the forms used by other steamship companies. Emphasis was placed on what reasonably could be expected. The court found that "Nothing whatever was done to impress the importance of the terms and conditions upon the passenger."[26]

The filled-in section or "box" of the *Silvestri* ticket bore the heading "Passage Contract" in Italian and English. Also within the box was a statement warning the passenger that the ticket was subject to terms and conditions printed on the cover of the ticket. The court found that the inconspicuousness of this statement in comparison with the other printed material inside the "box" did not afford reasonable notice to the passenger of the terms and conditions to which it referred.[27]

Although on its face the ticket does not incorporate the time limitation, the court apparently will allow the steamship company to prove the limitation is enforce-

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[22] *Id.* at 13.

[23] 298 F.2d 618 (2d Cir. 1962).

[24] Id. at 619.

[25] 388 F.2d 11, 17 (2d Cir. 1968).

[26] *Id.*

[27] The court, at page 14 of the opinion, had stated:

> Here the 'box' bore in the upper right hand corner the words:
>
> BIGLIETTO DI PASSAGIO
> PASSAGE CONTRACT
>
> followed by an identifying number, and in the lower right hand corner the validating stamp of the issuing travel agent. Almost all of the captions in the 'box' were in capital or boldface letters, the major exception being the following statements, which appeared in the upper left hand corner of the ticket in ordinary lower-case one-eighteenth inch type:
>
> . . . .
>
> Subject to the conditions printed on the cover of this ticket which form part of this contract.
>
> The inconspicuousness of these statements was increased by the fact that they were squeezed immediately below a caption in bold face and to the left of one in capital letters. The two 'leaves' which are an integral part of the coupon retained by the passenger were headed 'TERMS AND CONDITIONS' in boldface. Then followed 35 numbered paragraphs in very small print. At the end were spaces for the signature by or for the passenger, but neither Silvestri nor any representative signed.

Id. at 14.

able because the passenger had ample opportunity to become aware of the conditions on the ticket. The court states that:

> It may be argued also that the lawyer whom Silvestri consulted in Italy after he discarded the ticket should have been aware that steamship tickets commonly contain limitations on the time for bringing suit, could have obtained a duplicate from the Italian Line to which he complained, and perhaps even did so.[28]

The court also points out that if Silvestri had actual knowledge of the time limitation because of his lawyer's advice the case would be different. So it would seem that the Second Circuit will now apply a broader test in deciding whether conditions printed on a steamship ticket are binding on the passenger. It will look to the form of the ticket to see if it reasonably gives notice of the conditions, as compared with other tickets, and it will look to see if a particular passenger knew or reasonably should have known about the conditions.

The court has adopted the approach of the English cases which have considered whether a steamship ticket's terms and conditions can be binding on the passenger who accepts the ticket. The English courts since The *Majestic* have not been so concerned with whether the ticket is a contract, but whether, in the circumstances of a particular case, especially the opportunity afforded to learn of the conditions, the passenger was bound by them.

In *Marriott v. Yeoward Bros.*[29] the court found that the conditions printed clearly and legibly on the plaintiff's ticket were binding. Although the plaintiff had not known there were conditions on the ticket she had accepted, she did know that there was writing on the ticket in addition to her name. Therefore the defendant had done what was reasonably sufficient to bring the conditions on the ticket to the notice of the plaintiff. In *Cooke v. T. Wilson & Sons*[30] the terms and conditions were in plain legible type, and although the passenger knew that generally there were conditions relating to contracts of travel, she was not aware that they were on the particular ticket she had accepted. The court held that she ought to have been aware of the conditions, and shipping companies should not be made to provide for people who will not read what is put before them. In *Dill v. Grand Trunk Pacific Coast S.S. Co.*[31] the court found that the ticket was very common in appearance with the conditions on its face, that the plaintiff was acquainted with traveling on these boats, and that she had ample time to read the ticket. Therefore the company had done all that was reasonably required to notify the plaintiff and she was bound by the conditions. In the leading English case, *Hood v. Anchor Line (Henderson Bros.) Ltd.*,[32] the ticket was inside an envelope when given to the passenger's agent. On the outside of the envelope a printed finger pointed to the words "Please read conditions of the enclosed contract." On the face of the ticket, in large type were the words "Notice. This ticket is issued to and accepted by the passenger subject to the following conditions," and at the bottom of the ticket was another notice "Passengers are particularly requested to carefully read the above ticket." The House of Lords found that the passenger was given "conspicuous notice" and, while the defendant shipping company had the burden of proving it had done all it reasonably could to notify the passenger, the court was unable to see by what better

[28] *Id.* at 18.
[29] [1909] 2 K.B. 987.
[30] 32 T.L.R. 160 (1915).
[31] 21 B.C. 182 (1915).
[32] [1918] A.C. 837.

means the passenger would have been made knowledgeable that the ticket with its conditions would affect his legal rights.

In light of these English cases and the facts which Judge Friendly states may be important in the *Silvestri* case, it would seem that in the future the decisions on the question of whether the conditions printed on the steamship ticket are considered as part of a contract will not be as dependent on the form of the ticket. As long as the ticket attempts to notify the passenger of the conditions in a clear and legible manner the conditions will be binding if a reasonable passenger in the circumstances could or should have been aware of them. It is this last qualification as to the circumstances in which the passenger received the ticket that the earlier cases largely ignored. It was assumed that buying a steamship ticket was a matter of great deliberation and a passenger would naturally pay more attention than he would to something like a baggage check.[33] Therefore, if the ticket did incorporate the conditions printed on the ticket the passenger could not have been duped and the ticket would be no different than an insurance contract or a bill of lading. Examining the surrounding circumstances may prove to be a more practical way of determining whether or not the company has done all it can to warn the passenger that by accepting a ticket he is affecting his contract rights. But in light of the fact that most passengers do not even look at their tickets, even casually, and that they are unaware that tickets are contracts, it would seem that the theory of these cases should be the same as that in cases concerning baggage checks. In enforcing the conditions in *Murray*, Cardozo wrote that "a contract valid and reasonable in its inception does not become invalid and unreasonable thereafter"[34] because the passenger paid no attention to the conditions nor realized that there was any need to refer to them. If the steamship tickets were the result of negotiation between two equal parties, then it should be true that the passenger takes the risk of not reading the conditions. But even if the passenger is actually aware of the time limitations for filing suit printed on the ticket he has no alternative to accepting them. He must either take under the conditions printed on his ticket, or find some other way of getting where he wants to go. He never has the opportunity of bargaining with the steamship company.

The justifications for limitations on the monetary amount of liability on a ticket consist of the argument that unlimited liability would place too great a burden on the shipping industry. Furthermore, the passenger would be better able to estimate the possible extent of liability and thus be the better risk bearer. However, this is not the case with limitations on the time for filing suit. In upholding a limitation allowing forty days in which to give the steamship company notification of injury Justice Cardozo stated that:

> Limitations of this kind have their justification in the need of some safeguard to protect the carrier against fraud. Passengers on steamships scatter in all directions when the voyage is at an end. If claims may be presented at any time within the term of years permitted by the Statute of Limitations, the opportunity for investigation will often be lost beyond recall.[35]

Justice Cardozo seems to have forgotten that the court and jury system were desired as an intelligent way of deciding which claims deserve recompense and which do not.

In effect, *The Majestic* decision allowed steamship companies to place an extra burden on the plaintiff in getting his claim heard by a court. The lower courts have

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[33] Steers v. Liverpool, 57 N.Y. 1, 5 (1874).

[34] 235 N. Y. 162, 166; 139 N.E. 226, 228.

[35] *Id.* at 165.

shown their dissatisfaction with this by reading the ticket, until recently, as narrowly as possible in order to make the time limitations ineffective, and thereby protecting the plaintiff's cause of action. Since the enactment of U.S.C. § 183b(1) which was designed to eliminate abuses of shippers who put unreasonable time limitations in their tickets,[36] the courts have been more willing to enforce these limitations.[37] And, although the steamship company did lose in the appellate court in *Silvestri*, it is apparent that under the broader rule of *Silvestri* (i.e. considering the form of the ticket and the circumstances in which it was received), this trend will continue.

Cheryl Keith

HOUSING ACT—INJUNCTIVE RELIEF FOR PERSONS DISPLACED BY URBAN RENEWAL PROJECTS—*Norwalk CORE v. Norwalk Redevelopment Agency, 395 F.2d 920 (2d Cir. 1968)*—A new avenue of relief has been opened to "displacees" of urban renewal projects by the Second Circuit decision in *Norwalk CORE v. Norwalk Redevelopment Agency*.[1] The court held that persons displaced by such projects may seek equitable relief in federal courts when government efforts to assure their relocation have not been adequate under Section 105(c) of the Housing Act.[2]

Norwalk began as a class action brought by the Norwalk Chapter of the Congress of Racial Equality, two tenants' associations and several individuals representing low-income Negroes and Puerto Ricans. Plaintiffs joined as defendants the Norwalk Redevelopment Agency [hereinafter "the Agency"], the Department of Housing and Urban Development (HUD), private developers and several others connected with South Norwalk Project No. 1 (Project No. Conn. R-34).[3] They sought an injunction prohibiting construction of middle income housing which was planned for part of the site. They also sought an order directing construction of low income housing on that site for the minority groups so displaced.[4]

Plaintiffs asserted that a shortage of public and private housing and rampant discrimination in the Norwalk housing market limited the relocation facilities

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[36] Mulvihill v. Furness Withy & Co., 136 F. Supp. 201 (S.D.N.Y. 1955).

[37] 388 F.2d 11, 17.

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[1] 395 F.2d 920 (2d Cir. 1968).

[2] 42 U.S.C. § 1455(c) (Supp. 1967). This section provides that Loan and Capital Grant Contracts between the Federal government and municipal agencies under which federal funds are made available to municipalities for urban renewal projects shall require that —

> "(c) (1) There shall be a feasible method for the temporary relocation of individuals and families displaced from the urban renewal area, and there are being provided not generally less desirable in regard to public utilities and public and commercial facilities and at rents or prices within the financial means of the individuals and families displaced from the urban renewal area, decent, safe and sanitary dwellings equal in number to the number of and available to such displaced individuals and families and reasonably accessible to their place of employment . . ."

[3] 395 F.2d at 923. Under the Housing Acts of 1949 and 1954 42 U.S.C. §§ 1441-1460 (Supp. 1957), the Department of Housing and Urban Development (HUD) (formerly the Housing and Home Finance Agency) is authorized to enter into Loan and Capital Grant Contracts with Local Public Agencies (such as the Norwalk Redevelopment Agency). If certain conditions are met, including the relocation standard referred to in note 2, *supra*, HUD gives low-interest loans and grants to the Local Public Agencies (L.P.A.s). HUD also performs the function of insuring L.P.A. payment to private developers hired by the L.P.A.s.

[4] At this time the middle income housing planned for that part of the site has been constructed.

available to non-white displacees. The agency was aware of this situation at the time it contracted with HUD but it made no provision for housing the minority group families. Plaintiffs alleged that these families were relocated into substandard housing or forced to flee the city. White displacees, it was asserted, were not faced with similar hardships. Therefore, plaintiffs claimed that the Agency had intentionally denied the minority group displacees equal protection of the laws. Furthermore, HUD and the Agency had violated Section 105(c) of the Housing Act.

The Second Circuit held that displacees had standing to seek judicial relief for violation of Section 105(c) standards. Hitherto displacees had been denied standing on the basis of three theories: (1) that Congress intended to cut off review of the statute; (2) that all that Section 105(c) had established was contract rights between HUD and the Local Public Agencies[5] [hereinafter L.P.A.s]; and (3) that the interests of displacees was indistinguishable from the interests of the public at large.[6] The Court in *Norwalk* construed Congress' intention otherwise and recognized that the only persons affected by Section 105(c) were displacees.[7]

The Norwalk case will probably be remembered primarily for its holding that the plaintiffs' equal protection claim presented a justiciable issue. Generally, most state courts have been reluctant to hear challenges against urban renewal projects.[8] This reluctance stems from the difficulty of fashioning justiciable standards, the fear of encroaching on areas traditionally left to the legislatures, and the necessity of political discretion in this area.[9] Equal protection claims in connection with urban renewal projects have been shunned by federal courts for the same reasons. Thus, in *Harrison Halsted Community Group, Inc. v. Housing and Home Finance Agency*[10] and *Johnson v. Redevelopment Agency of the City of Oakland*,[11] the courts avoided reaching the merits on the equal protection claims by holding that the plaintiffs had no standing to sue. *In Progress Development Corp. v. Mitchell*,[12] plaintiffs charged the village with abusing the power of eminent domain. It was alleged that the village had condemned the site in question only because the developer had announced plans to sell plots to Negroes. The 7th Circuit held that this complaint presented a justiciable issue and ordered a trial on the merits to determine if the taking was done for a public purpose or was done intentionally to deprive the plaintiffs of their rights. But subsequent decisions confined the ruling in *Progress* to its facts. In *Green Street Association v. Daley*[13] the equal protection issue was raised but was not decided. There plaintiffs claimed that an urban renewal project was undertaken in order to create a no-Negro "buffer zone" between a residential area and shopping area. The court held that cases presenting challenges to urban renewal programs were matters for

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[5] See discussion, note 3, *supra.*

[6] Johnson v. Redevelopment Agency, 317 F.2d 872 (9th Cir.), *cert. denied* 375 U.S. 915 (1963); Green Street Association v. Daley, 373 F.2d 1 (7th Cir.), *cert. denied* 387 U.S. 932 (1967); Harrison-Halsted Community Group, Inc. v. Housing and Home Finance Agency, 310 F.2d 99 (7th Cir.), *cert, denied* 373 U.S. 914 (1963). For complete discussion see Note, 77 YALE L.J. 966 (1968).

[7] 395 F.2d at 932-36.

[8] *See*, Note, 77 YALE L.J. 966 (1968).

[9] Green Street Association v. Daley, 373 F.2d 1, 6-7 (7th Cir. 1967); Norwalk CORE v. Norwalk Redevelopment Agency, 395 F.2d 920, 926-28 (2d Cir. 1968).

[10] 310 F.2d 99 (7th Cir.), *cert. denied* 373 U.S. 914 (1963).

[11] 317 F.2d 872 (9th Cir.), *cert. denied* 375 U.S. 915 (1963).

[12] 286 F.2d 222 (7th Cir., 1961).

[13] 373 F.2d 1 (7th Cir.), *cert. denied* 387 U.S. 932 (1967).

condemnation proceedings in state courts. In dicta, the court expressed concern about the justiciability of the equal protection claim and indicated that it would not inquire into the issue even if such were properly before it.[14] The *Green Street* court distinguished *Progress* by finding that the complaint before it did not challenge the *use* of the power of eminent domain as a tool for discrimination, but only the defendants' motives for fashioning the plan. Plaintiffs objected to the manner in which the power was used, as manifested in various details of the plan. The court felt this aspect of the urban renewal plan was beyond judicial inquiry.

At about the same time *Green Street* was being decided, an Illinois District Court held a challenge to site selection policies of the Chicago Housing Authority to be justiciable. In *Gautreaux v. Chicago Housing Authority*[15] plaintiffs alleged that sites for public housing projects were selected for the purpose of maintaining existing patterns of discrimination. The court entertained only those counts which alleged deliberate intent to deprive plaintiffs of 14th amendment rights.

Unlike *Green Street* and *Gautreaux*, the Court in *Norwalk* was not faced with a challenge to the basic validity of an urban renewal plan. The Court was asked to hear a complaint which challenged only the proposed implementation of the relocation aspect of the program. To determine that such an issue was justiciable, the Court had to consider whether or not judicial inquiry would encroach on the legislative domain.[16] It acknowledged that its holding would affect the pace of relocation and hence the priority of goals in urban renewal planning. Nonetheless it felt that the relocation standard was set by the legislature. The adequacy of that standard was a political question into which the court could not inquire. The court could require only that the standard be met equally for all displacees. If this requirement resulted in delaying the program, the delay " . . . would be due to the standard, rather than its equal implementation for all."[17] Thus the court dealt with one barrier to a finding of justiciability.

Another barrier to holding plaintiffs' claim justiciable was not as adequately dealt with. In order to be considered justiciable, an issue must also be amenable to traditional judicial remedies.[18] Initially, the *Norwalk* court found that consideration of applicable remedies was inappropriate since the case was only at the pleading stage.[19] Thus, much of what is said in the decision about remedies must be considered dicta. However, should the allegations of the complaint be proven on remand, the District Court will face for the first time the problem of court

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[14] *Id.* at 5.

[15] 265 F.Supp. 582 (N.D. Ill. 1967).

[16] Baker v. Carr, 369 U.S. 186, 196-68 (1962). In defining justiciability, the court's inquiry should proceed to the point of deciding whether the duty asserted can be judicially molded. The "mere fact that the suit seeks protection of a political right does not mean it presents a political question," *Id.* at 209. Moreover, the Supreme Court stated:

> Appellants claim that they are being denied equal protection is justiciable and if discrimination is sufficiently shown, the right to relief under the equal protection clause is not diminished by the fact that the discrimination relates to political rights. *Id.* at 209-10.

The Court explained that an issue is non-justiciable if the court finds: (1) A demonstrable constitutional commitment to a coordinate political department. (2) Lack of judicially discoverable and manageable standards for resolving the problem. (3) The necessity of making an initial policy determination of a kind clearly for non-judicial discretion, 369 U.S. at 217.

[17] 395 F.2d at 930.

[18] *See*, discussion note 16, *supra.*

[19] 395 F.2d at 929.

fashioned remedies in this area. The dicta in *Norwalk*, then, assumes great importance both for what it did and did not say.

The Court began its review by stating that if the plaintiffs' allegations are proven, then

> . . . the most appropriate form of judicial relief . . . would be to require proof that the relocation standard is being met in general as adequately for non-whites as it is for whites before allowing the project to go forward. An affirmative form of relief, such as an order requiring the construction of low-income housing, would of course be much less appropriate, since it would necessarily involve the court in areas foreign to its experience and competence.[20]

The Court further stated the following:

> We do not understand plaintiffs' constitutional argument to be that defendants must end discrimination in the Norwalk open housing market through the relocation plan, or even that defendants must find integrated housing for those displaced by the Project. Those are arguments we need not consider until they are appropriately put to us.[21]

The suggestion seems to be that the District Court can fashion a remedy which will meet the plaintiffs' equal protection claim without insisting on integrated housing for plaintiffs or requiring defendants to end discrimination in the Norwalk Housing market. The Court suggests that the remedy would be adequate if it required the standard to be met as adequately for non-whites as it is for whites. It is the contention of this writer that given a factual situation similar to that outlined in the *Norwalk* complaint, a court order requiring the relocation to be accomplished as adequately for non-whites as it is for whites without a showing that integrated housing is being provided for the displacees would be a violation of the equal protection clause. It would seem that relocation of displacees into housing which conforms to existing discriminatory patterns would be state reinforcement of discrimination. Acknowledgement, reinforcement, or encouragement of such discrimination by an L.P.A. through its relocation efforts appears to violate the 14th Amendment.

This contention was urged in *Green Street Association v. Daley*.[22] The plaintiffs asserted that they had standing to raise the claim against HUD and the local defendants by virtue of Section 601 of the Civil Rights Act of 1964.[23] The Court held that the issue could not be asserted against the federal defendants since plaintiffs had not exhausted administrative remedies provided by Section 602 and 603 of the Act.[24] In dismissing the local defendants,[25] the court held that the L.P.A.s could not have a duty to end existing segregated housing patterns

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[20] *Id.* at 929-30.

[21] *Id.* at 930.

[22] 373 F.2d 1 (7th Cir.) *cert. denied* 387 U.S. 932 (1967).

[23] 42 U.S.C. § 2000(d) which provides:

> No person in the United States shall, on the ground of race, color, or national origin, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any program or activity receiving Federal financial assistance.

[24] 373 F.2d at 8-9. Plaintiffs might also have asserted standing under 42 U.S.C. 1983. In both *Norwalk*, 395 F.2d at 926 and *Gautreaux v. Chicago Housing Authority*, 265 F.Supp. 582 (N.D.Ill., 1967) the claim of standing to sue federal defendants was upheld under this section.

[25] Standing to assert claims against local defendants under 42 U.S.C. § 2000(d) is based on the interpretation given the section in *Bossier Parish School Board v. Lemon*, 370 F.2d 847 (5th Cir. 1967).

which were "accidental" to the relocation plan.[26] A similar fate met the argument in *Gautreaux v. Chicago Housing Authority*.[27] Plaintiffs were contesting L.P.A. site selection practices. In dismissing counts which did not allege *intentional* violation of the equal protection clause the court refused to condemn a housing program "even though it may not affirmatively achieve alterations in existing patterns of racial concentration in housing . . . . A showing of affirmative discriminatory state action is required."[28]

Thus, in the two cases which have considered the question, similar conclusions were reached. The courts will not rule on alleged equal protection violations in the relocation of displacees along existing segregated housing patterns unless there is a showing of affirmative state action which created the patterns or unless an intention to violate the equal protection mandate by the L.P.A. is demonstrated. These holdings seem to ignore Supreme Court prohibitions against state action which reinforces discrimination.[29] The Court in *Reitman v. Mulkey*[30] did not rely on a showing of previous affirmative state action creating discrimination to hold that a state may not encourage discrimination. Nor in *Burton v. Wilmington Parking Authority*[31] was a showing of an intention to reinforce discrimination necessary for a holding that such reinforcement violated the 14th Amendment. L.P.A. relocation of displacees into segregated housing patterns would seem to be state reinforcement of discrimination. It would seem that, under the doctrine of *Reitman v. Mulkey*, such reinforcement violates the equal protection clause. A holding that present relocation practices do in fact reinforce discrimination would force the L.P.A.s to change their relocation methods. It is difficult to imagine any alternatives to the present relocation practices which would not have the effect of promoting integration. Given a factual situation (as alleged in Norwalk) of rampant housing discrimination, the L.P.A. will have to find some method of housing displacees in integrated facilities in order to avoid reinforcing the existing discrimination. This housing might be found in areas which are already integrated. Relocating displacees in already integrated areas would expand the development of these areas without contributing to the existing pattern. Another alternative would be to place white displacees on non-white areas and non-white displacees in white areas. Again, this would promote integration. A third, more costly alternative would be to build new housing for the displacees. In order to avoid state action which segregates the races, the new housing would have to be integrated.[32] In other words, a court prohibition of L.P.A. reinforcement of existing

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[26] 373 F.2d at 9.

[27] 265 F.Supp. 582 (N.D.Ill. 1967).

[28] *Id.* at 584.

[29] Reitman v. Mulkey, 387 U.S. 369 (1967); Shelly v. Kramer, 334 U.S. 1 (1948); Burton v. Wilmington Parking Authority, 365 U.S. 715 (1965).

[30] 387 U.S. 369 (1967).

[31] 365 U.S. 715 (1965).

[32] Separate but equal facilities have been outlawed in every other area of public activity, Brown v. Board of Education, 347 U.S. 483 (1954) (schools); Dawson v. Mayor of Baltimore, 220 F.2d 386 (4th Cir.) *aff'd per curiam*, 350 U.S. 877 (1955) (public beaches and bathhouses); Holmes v. Atlanta, 223 F.2d 93 (5th Cir.) *aff'd per curiam*, 350 U.S. 879 (1955) (golf courses); New Orleans City Park Improvement Association v. Detiege, 358 U.S. 54 (1958) (parks); Burton v. Wilmington Parking Authority, 365 U.S. 715 (1965); Turner v. Memphis, 369 U.S. 350 (1961) (restaurants); Gayle v. Alabama Service Commission, 352 U.S. 903 (1956) (busses); Johnson v. Virginia, 373 U.S. 61 (1963) (seating in courtrooms). Determination in these cases of the definition of "public" activity rested both on the functions or kinds of services being offered and actual government involvement in the area. Under these

discrimination could conceivably compel the L.P.A.s into taking a more positive role in integrating the nearby areas through placement of displacees.

The conclusion that L.P.A.s may ultimately be required to take affirmative action to end discriminatory housing patterns may be reached by another method of reasoning. In *Gautreaux* and *Green Street,* the courts refused to act unless it could be shown that housing discrimination was more than "accidental" to the plan. They wanted proof that such had been caused by state action. Proof of discriminatory state action in the housing field could be shown by evidence that the courts in the State had once endorsed restrictive covenants,[33] or had adopted zoning ordinances along racial lines.[34] Direct state involvement in segregated housing might also be demonstrated by statistics of the Public Housing Administration.[35] But even if intentional discrimination by the state in the field of housing cannot be proven sufficiently, there can be little argument that state practices in the building of public housing and in relocating urban renewal displacees have reinforced and compounded the existing patterns.[36] Thus any holding that there was affirmative state action could trigger the type of remedies outline in the 1968 school de-segregation cases.[37] These cases held that the freedom of choice plans adopted by many school districts were ineffective remedies to the problem of school segregation.

While the Supreme Court did not hold in precise terms that the state had a positive duty to integrate, it did test those plans by noting how much integration had been achieved.[38] The Court cited with approval *United States v. Jefferson County School Board,*[39] which expressly held that a school board had an affirmative duty to integrate. Thus, once state action which reinforces discrimination in housing has been shown, court requirements to end it should be analogous to the kind of remedies ordered in the school cases i.e., a plan designed to promote integration before the project may go forward.

If, in *Norwalk,* the district court does not adopt this reasoning and proceeds to merely require that the relocation standard be met as adequately for non-whites as for whites, a violation of the equal protection clause may occur. Given the shortage of housing alleged in the complaint, the L.P.A. would probably elect to build housing for the Negro and Puerto Rican families. This alternative would seemingly be analagous to providing "separate but equal" facilities which has been rejected in all other areas of public accommodation.[40] To avoid such a result, the Norwalk situation would require the construction of integrated housing or the relocation of displacees in standard housing not yet integrated. A lengthy discourse would be required to show how this might be done without state encroachment on individual rights. As a consequence, only a few suggestions can be mentioned.

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cases it would seem that public housing is "public" even though the governmental function performed is performed by private developers.

[33] Reitman v. Mulkey, 387 U.S. 369 (1967); Barrows v. Jackson, 346 U.S. 249 (1953).

[34] Buchanan v. Warley, 245 U.S. 60 (1917).

[35] Of all existing projects in the Public Housing Administration (PHA) program, 1179 were all white, 1174 were all Negro and 675 were integrated, PUBLIC HOUSING ADMINISTRATION, TRENDS TOWARD OPEN OCCUPANCY, REP. NO. 12 (1963).

[36] Luttrell, *The Public Housing Administration and Discrimination in Federally Assisted Low Rent Housing,* 64 MICH. L.R. 871 (1965-6).

[37] Green v. County School Board, 391 U.S. 430 (1968); Monroe v. Board of Education, 391 U.S. 443; Raney v. Board of Education, 391 U.S. 443 (1968).

[38] Green v. County School Board, 391 U.S. 430, 439-42 (1968).

[39] 372 F.2d 836, 869, *aff'd en banc,* 380 F.2d 385 (5th Cir. 1967).

[40] *See* cases cited, note 32, *supra.*

In *Green Street* the court said that "[t]he city admittedly could not require relocation in any particular area; it may only determine what housing is available in fact and offer whatever assistance it can in furnishing this information to displacees. The local defendants may not be enjoined from proceeding with the plan simply because the plan fails to include what the local defendants would be powerless to enforce — "integrated' relocation."[41] Hence, L.P.A.s may not insist that displacees move into a certain area under the present system. They may not even insist that displacees relocate in §105(c) standard housing.[42] However, when submitting applications for loan and capital grant contracts they must show that adequate relocation facilities exist for displacees or will be built for them in the area.[43] The L.P.A.s are required to maintain relocation offices on the urban renewal site to assist displacees in finding housing.[44] They are also prohibited from listing any landlord who discriminates.[45] Where resort to public and private housing would be futile, due to existing shortages, the L.P.A.s are obligated to provide housing for those displaced. Initially, L.P.A.s might avoid the mistakes made in the past by choosing a site for projected housing which would not lend itself to easy racial classification by prospective tenants.[46] To maintain a racial balance within the building(s) one of two methods might be adopted. Benign quotas might be used. Racial classification has been held permissible when the purpose is to achieve equality and avoid unequal treatment.[47] Faced with the reality that housing, initially integrated, often becomes a ghetto for one race or another, a court may look favorably on a system of quotas.[48] Another method to insure the integration of new housing would be to require the pooling of all applications for public housing in a central office. Applicants for public housing would be assigned as vacancies occur. This would prevent the problems encountered by local housing authorities under the present tenant choice

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[41] 373 F.2d at 9.

[42] 42 U.S.C. § 1455 (Supp. 1967). See U.S. DEPARTMENT OF HOUSING AND URBAN RENEWAL, URBAN RENEWAL HANDBOOK, RHA 7212.1 (1968).

[43] 42 U.S.C. § 1455(c) (Supp. 1967).

[44] U.S. DEPARTMENT OF URBAN RENEWAL, URBAN RENEWAL HANDBOOK, RHA 7212.1 (1968).

[45] *Id.* at 4-5. 1 HOUSING AND HOME FINANCE AGENCY, URBAN RENEWAL MANUAL 4-2-2, Exhibit C (1967).

[46] See Luttrell, note 36, *supra.*

[47] Norwalk CORE v. Norwalk Redevelopment Agency, 392 F.2d 920, 931-32 (2d Cir. 1968). It is interesting to note that such classification already takes place. HUD requires LPA bookkeeping of relocation to be kept separately for each racial group and requires units available in the community to be listed according to "racial availability," DEPARTMENT OF HOUSING AND URBAN RENEWAL, URBAN RENEWAL HANDBOOK, Ch. 2, RHA 7212.1. Under the HHFA requirements, if the L.P.A.s find the project will result in a "substantial net reduction in the supply of housing in the project area available to minority group families . . ." the project may proceed only if:

> (1) Standard housing replacing the loss is provided elsewhere in the community in new or existing dwelling units not previously available to the minority group. DEPARTMENT OF HOUSING AND HOME FINANCE, 1 HOUSING RENEWAL MANUAL, 10-1 at 1.

Although the bookkeeping methods are open to some question as to the purpose for which they have been used in the past (i.e., whether or not the determination of "racial availability" of units might not have resulted in a reinforcement of already existing patterns of discrimination) it is clear from the HHFA requirements that positive action by the L.P.A.s to end the discrimination has at least been contemplated by the Agency.

[48] For an interesting discussion of the constitutionality of benign quotas see Bittker, *The Case of the Checker-Board Ordinance*, 71 YALE L.J. 1387 (1962).

plans. Prospective tenants would no longer be able to choose projects according to racial preference.[49] Of course both these plans would require new HUD and Public Housing Authority regulations. The statutory authority might be found by new judicial interpretation of §601 of the 1964 Civil Rights Act.[50]

Integration of housing might also be aided by rent subsidization plans.[51] HUD has already begun to make strides under §101 of the Housing and Urban Development Act of 1965. The progress made in this program, however, is necessarily slow due to the eligibility requirements of private sponsors, the limits placed on tenant eligibility and site selection practices.[52] This program might well be expanded by appropriate legislation. In addition, the Widnall Plan[53] through which subsidies are paid to landlords of existing housing might be used effectively.[54] "Vest Pocket" housing programs which envision scattered location of small units in a neighborhood formerly not integrated, creating a racial mix rather than racial concentration, might be tried.

It has often been said that the necessity of experimentation on such a difficult social problem precludes court enforcement because of the fear that executive discretion will be stifled. The school desegregation cases and the history of court enforcement since *Brown v. Board of Education* should dispel this notion.[55] Experience with reapportionment cases also shows the flexibility of judicial remedies.[56] It has also been asserted that the government is powerless to prevent whites from fleeing their neighborhoods to escape integration. However, it is believed that integrated government housing programs which are attractive in terms of facilities and financial benefits may counteract this tendency.

In summary, the fear of lack of enforceable standards should not dissuade courts from requiring L.P.A.s to cease reinforcing existing patterns of discrimination. Court enforcement may be confined, as in the school desegregation cases, to approval of plans according to their effects in achieving integration. It would be premature to rule that local and federal agencies are incapable of working out a plan which will promote housing integration.

Freda F. Bein

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[49] *See* Luttrell, note 36, *supra.*

[50] *See* 42 U.S.C. § 2000(d) (Supp. 1967).

[51] Housing and Urban Development Act of 1965, § 101, 12 U.S.C. § 1701s (Supp. I, 1965); Housing and Urban Development Act of 1965 § 23, 42 U.S.C. § 1421(b) (Supp. I, 1965).

[52] Housing and Urban Development Act of 1965 § 101 (b)(c)(f), 12 U.S.C. § 1701s (b)(c)(f).

[53] Housing and Urban Development Act of 1965 § 23, 42 U.S.C. § 1421(b) (Supp. I, 1965).

[54] For a good discussion of provisions of rent subsidization programs and their effectiveness in achieving integration, see Ellickson, *Government Housing Assistance to the Poor,* 76 YALE L.J. (1966-7).

[55] Brown v. Board of Education, 347 U.S. 483 (1954). United States v. Jefferson County Board of Education, 372 F.2d 836, *aff'd en banc,* 380 F. 2d 385 (5th Cir. 1967). See footnote 38.

[56] Every district court since Douglas' suggestion in Baker v. Carr, 369 U.S. 186, 250 n. 5 (1962) has, when confronted with the problem allowed the legislature some time to handle the problem of reapportionment itself. *See, e.g.,* Davis v. Cameron, 238 F. Supp. 462 (S.D. Iowa, 1965); Petusky v. Clyde 234 F. Supp. 960 (D.Utah, 1964). See Comment, 13 U.C.L.A. L. REV. 1345 (1965-6).