Volume 21 | Issue 2 Article 4

1976

Constitutional Law - Civil Rights - Discrimination against Blacks in Admissions to Private Schools Violates the Right to Contract Guaranteed by Section 1981

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RECENT DEVELOPMENTS

CONSTITUTIONAL LAW — CIVIL RIGHTS — DISCRIMINATION AGAINST BLACKS IN ADMISSIONS TO PRIVATE SCHOOLS VIOLATES THE RIGHT TO CONTRACT GUARANTEED BY SECTION 1981.

McCrary v. Runyon (4th Cir. 1975)

Fairfax-Brewster School (Fairfax-Brewster) and Bobbe's Private School (Bobbe's) are private educational institutions.[1] In May 1969, the parents of Colin M. Gonzales attempted to have their son admitted to the first grade of Fairfax-Brewster and Bobbe's,[2] but were rejected by both because Colin was black.[3] In August 1972, Michael McCrary was also refused admission at Bobbe's because of his race.[4] Claiming a violation of their civil right to contract under section 1981,[5] Colin Gonzales filed suits

1. Gonzales v. Fairfax-Brewster School, Inc., 363 F. Supp. 1200, 1201 (E.D. Va. 1973). "Neither school receives any assistance, financial or otherwise, from any state, local or federal agency; and each relies entirely on funds derived from tuition paid by students to support its operations." *Id.*

2. Colin Gonzales' parents learned of Fairfax-Brewster through a mass mailing, an advertisement in the classified section of the telephone directory, and from a friend. McCrary v. Runyon, 515 F.2d 1082, 1084 (4th Cir.), *cert. granted,* 96 S. Ct. 354 (1975). The Fourth Circuit consolidated five cases on appeal, 515 F.2d at 1082, and in four of the cases certiorari was applied for and granted by the Supreme Court of the United States; Runyon v. McCrary, 96 S. Ct. 354 (1975) (No. 75–62); Fairfax-Brewster School, Inc. v. Gonzales, *id.* (No. 75–66); Southern Indep. School Assoc. v. McCrary, *id.* (No. 75–278); McCrary v. Runyon, *id.* (No. 75–306). For a summary of the questions presented in each case, *see* 44 U.S.L.W. 3270–71 (U.S. Nov. 11, 1975).

3. 515 F.2d at 1085–86. The Gonzaleses had applied for admission to Fairfax-Brewster's summer camp with a view towards having Colin admitted to the first grade. *Id.* at 1084. The school testified that the reason for rejecting the application was that the kindergarten that Colin had attended gave him insufficient preparation for the first grade, and therefore it would be useless to allow him to enter the summer camp only to have to "yank him out" at the beginning of the academic year. *Id.* at 1085. However, the trial court found this testimony to be "unbelievable," and it concluded that the real reason for the rejection was because Colin was black. 363 F. Supp. at 1202.

On telephoning Bobbe's, the Gonzaleses were told that the school did not accept blacks. 515 F.2d at 1085. The trial court held that it was of "no moment that no formal application was filed." 363 F. Supp. at 1203.

4. 515 F.2d at 1085. Mrs. McCrary learned of Bobbe's from an advertisement in the classified section of the telephone directory. 363 F. Supp. at 1202. No formal application was made since, upon inquiry, Mrs. McCrary was told that Bobbe's did not accept blacks. 515 F.2d at 1085.

5. 42 U.S.C. § 1981 (1970). Section 1981 provides:

> All persons within the jurisdiction of the United States shall have the same right in every State and Territory to make and enforce contracts, to sue, be parties, give evidence, and to the full and equal benefit of all laws and proceedings for the security of persons and property as is enjoyed by white citizens, and shall be subject to like punishment, pains, penalties, taxes, licenses, and exactions of every kind, and to no other.

Id.

against both Fairfax-Brewster and Bobbe's while Mr. and Mrs. McCrary and Michael filed suit solely against Bobbe's.[6] The actions were consolidated for trial[7] before the United States District Court for the Eastern District of Virginia which, in addition to permanently enjoining the defendants from discriminating against blacks in enrollment in their schools, awarded damages for embarrassment, humiliation, and mental anguish to the plaintiffs.[8] The United States Court of Appeals for the Fourth Circuit affirmed the district court's finding of a section 1981 violation,[9] *holding* that section 1981 prohibits racial discrimination in private contractual arrangements and that consequently the defendants had violated the plaintiffs' civil rights by denying them admission to these private schools solely upon the basis of race. *McCrary v. Runyon,* 515 F.2d 1082 (4th Cir.), *cert. granted,* 96 S. Ct. 354 (1975) (Nos. 75-62, 75-66, 75-278, 75-306).

The Civil Rights Act of 1866 (1866 Act)[10] was enacted pursuant to the enforcement clause of the thirteenth amendment[11] in order to guarantee for blacks the benefits of citizenship which were incident to the freedom which that amendment declared.[12] However, during the century after its passage, the statute was ineffective in accomplishing its purpose,

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6. 363 F. Supp. at 1203.

7. 515 F.2d at 1084. The Southern Independent School Association intervened, claiming that section 1981 did not prohibit racial discrimination in private schools. *Id.* As of 1971, the Association represented 396 schools with a combined enrollment of 176,000. Note, *Segregation Academies and State Action,* 82 YALE L.J. 1436, 1448 (1973). These schools were located in Alabama, Georgia, Louisiana, Mississippi, North Carolina, South Carolina, and Virginia. *Id.*

8. 363 F. Supp. at 1205. The court also awarded attorney's fees. *Id.*

9. However, the court reversed the award of attorney's fees since there was no finding of "obstinate obduracy" on the part of the defendant. 515 F.2d at 1089.

10. Act of April 9, 1866, ch. 31, 14 Stat. 27. The Civil Rights Act of 1866 provides in pertinent part:

> [A]ll persons born in the United States and not subject to any foreign power . . . are hereby declared to be citizens of the United States; and such citizens, of every race and color, without regard to any previous condition of slavery or involuntary servitude . . . shall have the same right, in every State and Territory in the United States to make and enforce contracts, to sue, be parties, and give evidence, to inherit, purchase, lease, sell, hold, and convey real and personal property . . . as is enjoyed by white citizens . . . .

Id. § 1.

There is some confusion as to the exact derivation of 42 U.S.C. § 1981, but it was determined in Jones v. Alfred H. Mayer Co., 392 U.S. 409 (1968), that it is derived from section 1 of the Civil Rights Act of 1866. *Id.* at 441 n.78. For further discussion on the derivation of section 1981, *see* note 24 *infra.*

11. The thirteenth amendment to the United States Constitution provides:

> Section 1. Neither slavery nor involuntary servitude, except as a punishment for crime whereof the party shall have been duly convicted, shall exist within the United States, or any place subject to their jurisdiction.
>
> Section 2. Congress shall have power to enforce this article by appropriate legislation.

U.S. CONST. amend. XIII.

12. *See* Gressman, *The Unhappy History of Civil Rights Legislation,* 50 MICH. L. REV. 1323, 1325-28 (1952); tenBroek, *Thirteenth Amendment to the Constitution of the United States,* 39 CALIF. L. REV. 171, 186 (1951).

largely due to the fact that the United States Supreme Court in *Hodges v. United States*[13] held that the 1866 Act could not be interpreted to give one individual a right of redress against another.[14]

It was not until 1968 that the Civil Rights Act of 1866 was put to effective use.[15] In *Jones v. Alfred H. Mayer Co.*,[16] the plaintiff alleged a section 1982[17] violation in that the defendant refused to sell him a house because he was black.[18] In an opinion by Justice Stewart, the Court held that in view of the text[19] and of the legislative history[20] of the statute, section 1982 was intended to reach private discrimination,[21] and that, so construed, the statute was a valid exercise of Congress' power under the enforcement clause of the thirteenth amendment.[22] In so holding,

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13. 203 U.S. 1 (1906). The *Hodges* Court reversed convictions under sections 1977 and 5508 of the Revised Statutes, U.S. REV. STAT. §§ 1977, 5508 (1874) (now codified at 42 U.S.C. § 1981 (1970) and 18 U.S.C. § 241 (1970) respectively). The defendants had been charged with conspiring to deny blacks their right to contract for employment. 203 U.S. at 2.

14. 203 U.S. at 18. Such an interpretation would follow from the Court's holding in the Civil Rights Cases, 109 U.S. 3 (1883), that although the thirteenth amendment empowered Congress to enact "primary and direct" legislation "for the obliteration and prevention of slavery with all its badges and incidents," it only guaranteed that blacks would not be subject to compulsory servitude or hindered by legal incapacity or disability. *Id.* at 21–22; *see* Note, *Federal Power to Regulate Private Discrimination: The Revival of the Enforcement Clauses of the Reconstruction Era Amendments*, 74 COLUM. L. REV. 449, 453 (1974).

15. Most advances in the civil rights movement since the Civil Rights Cases, 109 U.S. 3 (1883), have come about through judicial enforcement of the fourteenth amendment, which applies to state action. Note, note 14 *supra*, at 450–51.

16. 392 U.S. 409 (1968).

17. 42 U.S.C. § 1982 (1970). Section 1982 provides:

> All citizens of the United States shall have the same right, in every State and Territory, as is enjoyed by white citizens thereof to inherit, purchase, lease, sell, hold, and convey real and personal property.

Id.

18. 392 U.S. at 412.

19. The *Jones* Court viewed section 2 of the 1866 Act, Act of April 9, 1866, ch. 31, § 2, 14 Stat. 27, which provided criminal penalties for violating section 1, as exempting private violations from criminal sanctions. *Id.* at 424–25. The Court reasoned that such an exemption would not be necessary if section 1 was not intended to reach private discrimination. *Id.* at 425–26.

The defendants' contention that the 1866 Act was enacted solely to prohibit such discriminatory legislation as the Black Codes was dismissed since the language of the 1866 Act "was far broader than would have been necessary to strike down discriminatory statutes." *Id.* at 426–27.

20. The *Jones* Court based its analysis of the legislative history upon three factors. The first was a report before Congress stressing "the prevalence of private hostility toward Negroes and the need to protect them from the resulting persecution and discrimination." *Id.* at 428. Second, the Court reasoned that congressional rejection of three proposals to invalidate discriminatory state statutes as being "too narrowly conceived" supported the inference that Congress' intent in passing the 1866 Act was broader than merely invalidating such statutes. *Id.* at 429. Third, the Court relied upon statements by members of Congress, particularly Senator Trumbull, the sponsor of the Act, who felt that it would " 'break down *all* discrimination between black men and white men.' " *Id.* at 432, *quoting* CONG. GLOBE, 39th Cong., 1st Sess. 43 (1866) (remarks of Senator Trumbull) (emphasis supplied by the Court).

21. *Id.* at 436–37.

22. *Id.* at 438–39. For the text of the thirteenth amendment, *see* note 11 *supra*.

the Court expressly overruled *Hodges*,[23] which ruling, combined with the Court's reference to the common origin of sections 1981 and 1982, suggested that section 1981 also applied to private discrimination.[24]

The Court had an opportunity to expand on this holding in *Sullivan v. Little Hunting Park, Inc.*[25] and in *Tillman v. Wheaton-Haven Recreation Association, Inc.*[26] In *Sullivan*, the Court found that a nonstock membership corporation, which had set up a community park for the benefit of residents in the community but had refused membership to a black resident,[27] violated section 1982[28] since the park's recreational facilities were so intimately related to the property and since there was no "plan or purpose of exclusiveness" other than race.[29] Confronted with a similar

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23. *Id.* at 441 n.78. The Court held that the *Hodges* Court had defined Congress' thirteenth amendment enforcement power too narrowly in holding that only conduct which actually enslaves someone could be subject to legislation under the thirteenth amendment. *Id.* Such a holding, the Court reasoned, was inconsistent with the view taken in the Civil Rights Cases, 109 U.S. 3 (1883), that the thirteenth amendment authorized Congress "to eradicate the last vestiges and incidents of a society half slave and half free." 392 U.S. at 441 n.78. The *Jones* Court, however, may have misinterpreted the *Civil Rights Cases* since it appears that that case characterized the 1866 Act only as a legal capacity measure. *See* 109 U.S. at 22.

24. 392 U.S. at 441 n.78. The Court implied that since both sections 1981 and 1982 were derived from section 1 of the 1866 Act, section 1981 should likewise apply to private discrimination. *Id.*

This analysis, however, is not without its pitfalls. Although section 1981 covers the same subject matter as section one of the 1866 Act, the language of section 1981 is nearly identical to section 16 of the Civil Rights Act of 1870 (1870 Act), Act of May 31, 1870, ch. 114, § 16, 16 Stat. 144. The 1870 Act, which was essentially a voting rights act, was passed to secure rights for aliens, particularly the Chinese, and it has been held that it was based upon the fourteenth rather than the thirteenth amendment. Cook v. Advertiser Co., 323 F. Supp. 1212 (M.D. Ala. 1971), *aff'd on other grounds*, 458 F.2d 1119 (5th Cir. 1972). For a good discussion of the 1870 Act and its relation to the 1866 Act, *see* Kohl, *The Civil Rights Act of 1866, Its Hour Come Round At Last*, 55 VA. L. REV. 272, 295–99 (1969).

The derivation of section 1981 is further confused by the fact that the historical note under section 1981 in the United States Code lists the 1870 Act as its source without reference to the 1866 Act, while under section 1982, only the 1866 Act is listed. *Compare* 42 U.S.C. § 1981 (1970), *with id.* § 1982. This confusion, however, is probably attributable to a mistake of the codifier. Note, *Section 1981 and Private Discrimination: An Historical Justification for a Judicial Trend*, 40 GEO. WASH. L. REV. 1024, 1036–43 (1974). In 1866, Congress authorized the codification of statutes and in 1874 the Revised Statutes were approved. *Id.* at 1037. The argument has been made that in making this codification, the codifier erred in deleting the "right to contract" language from section one of the 1866 Act and in assuming that the 1870 Act covered the same subject matter as the 1866 Act. *Id.* at 1038–39. *See also* Young v. ITT, 438 F.2d 757, 759 (3d Cir. 1971).

25. 396 U.S. 229 (1969).

26. 410 U.S. 431 (1973).

27. 396 U.S. at 234–35. Although members were entitled to assign their share to their lessee, plaintiff was expelled from membership when he attempted to assign his share to his black lessee, a co-plaintiff. *Id.*

28. *Id.* at 237. Suit was also brought under section 1981, but the Court did not discuss that statute. *See id.* at 235.

29. *Id.* The Court reasoned that since there was no "plan or purpose of exclusiveness," there was no need to consider whether or not the defendant was entitled to a private club exemption under section 201(e) of the Civil Rights Act of 1964, 42 U.S.C. § 2000a(e) (1970). 396 U.S. at 236.

situation,[30] the *Tillman* Court reinforced the holding in *Sullivan*,[31] and expanded it further by implicitly holding that a refusal to admit black guests to a privately owned community swimming pool denied a potential black guest his right to contract under section 1981.[32]

It was against this background that the *McCrary* court confronted the question of whether to extend the protection afforded by section 1981 so as to prohibit racial discrimination in admissions to private schools.[33] In answering this question in the affirmative, the court made two key determinations: first, in light of the legislative history of section 1981 and the judicial precedent interpreting that statute, section 1981 prohibited such discrimination;[34] and second, that so construed, the statute was not violative of the constitutional rights of association and privacy.[35]

Although the court seemed to disagree with the *Jones* Court's reading of the legislative history,[36] it nevertheless felt bound by that interpretation and by the *Sullivan* and *Tillman* decisions.[37] In particular, the court reasoned that since *Tillman* implicitly authorized the application of section 1981 to private discrimination in contractual arrangements,[38] and that since admission is a part of the process of forming the contractual relationship between the school on the one hand and a pupil and his parents

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30. In *Tillman*, an association organized for the purpose of operating a swimming pool extended membership preference to those living within a certain geographic area, although persons living outside the area were allowed to join upon the recommendation of a member. 410 U.S. at 432–33. Plaintiff Press bought a home within the preference area but was denied membership because he was black. *Id.* at 433–34. Plaintiff Tillman brought a black guest to the pool and the following day the guest policy was changed in order to exclude blacks. *Id.* at 434. Press, Tillman, and the guest brought suit under sections 1981 and 1982 to enjoin such activities. *Id.*

31. The Court held that *Sullivan* was controlling with respect to the section 1982 claims of Press and Tillman. *Id.* at 435, 438.

32. *Id.* at 439–40. It should be noted that the *Tillman* Court specifically dealt only with the claim that Wheaton-Haven was exempt from section 1981 because it was a private club. *Id.* at 440. Concluding that it was not, the Court refused to rule on whether section 1981 contained a private club exemption, but instead it remanded the case in order for the trial court to determine whether there was in fact discrimination. *Id.* It is submitted that, in making this ruling, the Supreme Court tacitly determined that section 1981 proscribed private discrimination.

33. Two district court cases had previously dealt with this problem. In Grier v. Specialized Skills, Inc., 326 F. Supp. 856 (W.D.N.C. 1971), section 1981 was applied so as to prohibit discrimination in admission to a barber training school. Riley v. Adirondack S. School for Girls, 368 F. Supp. 392 (M.D. Fla. 1973), involved facts very similar to those in *McCrary*, but it held that the black plaintiffs were not entitled to relief since they did not meet the admission requirements.

34. 515 F.2d at 1087.

35. *Id.* at 1087–88.

36. *Id.* at 1087. For an outline of the *Jones* interpretation of the legislative history of sections 1981 and 1982, *see* note 20 *supra*.

The *Jones* decision generated much discussion among legal commentators. For a good analysis supporting the holding in *Jones*, *see* Kohl, note 24 *supra*, at 283–92. For a contrary view, *see* Ervin, *Jones v. Alfred H. Mayer Co.: Judicial Activism Run Riot*, 22 VAND. L. REV. 485 (1969).

37. 515 F.2d at 1087. For an analysis of the *Sullivan* and *Tillman* cases, *see* notes 28–34 and accompanying text *supra*.

38. *See* notes 30–32 and accompanying text *supra*.

on the other hand,[39] a denial of admission to a private school would violate a black's right to contract that is guaranteed by section 1981.[40]

Having interpreted section 1981 as prohibiting discrimination in private contractual arrangements,[41] the court considered whether section 1981, as interpreted, violated the constitutional rights of privacy and association. In recognizing a constitutionally protected right of free association,[42] the court viewed that right as inextricably linked to freedom of speech.[43] Since there was no showing that "discontinuance of their discriminatory admission practices would inhibit in any way the teaching in these schools of any ideas or dogma,"[44] and since section 1981 did not impede parents in their exercise of a choice of a private school which presented ideas or utilized educational methods not available in the public schools, the court concluded that freedom of association was not infringed.[45]

The court also concluded that its interpretation of section 1981 was not violative of the right of privacy,[46] reasoning that such a right has been deemed constitutionally protected only when it related to "a few

39. 515 F.2d at 1087. Although the court did not cite any authorities on this point, several cases have held that the relationship between a pupil and a private school is contractual in nature. *E.g.,* John B. Stetson Univ. v. Hunt, 88 Fla. 510, 102 So. 637 (1924); Robinson v. University of Miami, 100 So. 2d 442 (Fla. Dist. Ct. App.), *cert. denied,* 104 So. 2d 595 (Fla. 1958); People *ex rel.* Tinkoff v. Northwestern Univ., 333 Ill. App. 224, 77 N.E.2d 345 (1947); Booker v. Grand Rapids Medical College. 156 Mich. 95, 120 N.W. 589 (1909).

40. 515 F.2d at 1087. The court, however, did provide a final caveat to its interpretation when it noted that section 1981 was not intended to restrict the school in its use of racially neutral qualifications. *Id.* As the court pointed out:

> All that is contended and all that we hold is that § 1981 prohibits the rejection of a black applicant when his qualifications meet all other requirements *and race is the only basis for his rejection.*

Id. (emphasis added).

41. *See* notes 36–40 and accompanying text *supra.*

42. 515 F.2d at 1087.

43. *Id.* The court stated: " 'It is beyond debate that freedom to engage in association for the advancement of beliefs and ideas is an inseparable aspect of * * * freedom of speech.' " *Id., quoting* NAACP v. Alabama, 357 U.S. 449, 460 (1958).

44. 515 F.2d at 1087.

45. *Id.*

46. *Id.* at 1087–88. In reaching its conclusion that section 1981, as interpreted, was not unconstitutional, the court dismissed the contention of the defendants that Norwood v. Harrison, 413 U.S. 455 (1973), compelled a different result. The court reasoned that *Norwood,* on its facts, did not present the question of whether private, segregated schools violated section 1981. 515 F.2d at 1087. In *Norwood,* the Supreme Court struck down a Mississippi statute giving free textbooks to all students in both public schools and private segregated schools. 413 U.S. at 466.

The defendants in *McCrary* relied on dicta in *Norwood* that "private bias is not barred by the Constitution," *id.* at 469, and, in fact, "may be characterized as a form of exercising freedom of association protected by the First Amendment," *id.* at 470, to support their argument that the students' rights of privacy and association would be violated if racial discrimination in private schools was prohibited. 515 F.2d at 1088; 363 F. Supp. at 1204.

The *McCrary* court, noting that *Norwood* dealt with the question of whether a state could give aid to a private, segregated school and not whether citizens had a right to maintain such schools, concluded that "the observation in *Norwood* [that private bias may be constitutionally protected] is far from a holding that segregation in a private school is constitutionally protected." 515 F.2d at 1088.

people . . . involved in an activity unintended for the public view."[47] Concluding that admission to private schools did not fall within the zone of privacy, the court bolstered its argument by noting that a school which utilizes advertisements to attract students cannot be truly private.[48]

While the rights of privacy and association may ultimately determine the validity of a statute, the pivotal issue which confronted the *McCrary* court was whether the right to contract guaranteed by section 1981 included the right to attend a private school. In light of *Jones* and *Tillman,* the conclusion that section 1981 applies to private discrimination is inescapable.[49] However, there are at least two routes that the *McCrary* court could have taken in defining "contract," as employed in section 1981.[50]

First, "contract" could be defined, according to its ordinary usage, as *any* "agreement, upon sufficient consideration, to do or not to do a particular thing."[51] This broad approach, apparently adopted by the *McCrary* majority,[52] is supported by the seemingly sweeping language of the 1866

47. *Id.* at 1088, *citing* Roe v. Wade, 410 U.S. 113 (1973), *and* Griswold v. Connecticut, 381 U.S. 479 (1965).

48. 515 F.2d at 1089. The *McCrary* court left open the possibility that some schools may be so private as to possess a rule of exclusivity inoffensive to section 1981. *Id.* at 1088. In particular, the court would exclude from the scope of section 1981 the situation where a family employs tutors for their children, but would not exclude Fairfax-Brewster and Bobbe's since "[t]heir actual and potential constituency . . . is more public than private. They appeal to the parents of *all* children in the area who can meet their academic and other admission requirements." *Id.* at 1088–89 (emphasis added).

49. The Supreme Court has not specifically ruled on the interpretation of section 1981. Since *Jones* was decided under section 1982 (*see* notes 16–24 and accompanying text *supra*) a narrow interpretation of its holding would leave open the question of whether section 1981 would necessarily apply to private discrimination. *Tillman,* while holding that the defendant was not a private club, and thus not exempt from section 1981, only implied in its holding that section 1981 applies to private discrimination. *See* notes 30–32 and accompanying text *supra.* In light of references in both *Jones,* 392 U.S. at 441 n.78, and *Tillman,* 410 U.S. at 440, as to the common derivation of sections 1981 and 1982, and in light of the *Jones* Court's reliance on remarks in the congressional debates that the 1866 Act would abrogate "'*all* discrimination,'" 392 U.S. at 432, *quoting* CONG. GLOBE, 39th Cong., 1st Sess. 43 (1866) (remarks of Senator Trumbull) (emphasis supplied by the Court), it would be difficult to hold that section 1982 proscribes private discrimination while section 1981 does not.

50. Certainly, a thorough examination of the legislative debates would have to be made before definitively interpreting any statute. However, it is questionable whether such an examination would reveal much in the instant case, in light of the confusion surrounding the debates on the Civil Rights Act of 1866. *Compare* Jones v. Alfred H. Mayer Co., 392 U.S. 409, 426–36 (1968) (majority opinion) (debates show 1866 Act proscribed private discrimination), *with id.* at 454–73 (Harlan, J., dissenting) (debates show 1866 Act did not proscribe private discrimniation).

51. 2 W. BLACKSTONE, COMMENTARIES *442. Professor Williston, on the other hand, defines contract as "a promise, or set of promises, for breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty." 1 S. WILLISTON, CONTRACTS § 1 (3d ed. 1957).

52. For a discussion of the majority's analysis of section 1981, *see* notes 36–40 and accompanying text *supra.* In contrast, the dissent urged that a distinction should be made between purely commercial contracts, such as buying and selling property, and status contracts, such as that involved between a teacher and a student, which might involve a more personal relationship. 515 F.2d at 1093 (Russell, Field & Widener, J.J.,

Act.[53] However, unless it can be said that discrimination in *every* contractual arrangement is a badge or incident of slavery, it appears that the statute, construed in this way, exceeds the enforcement powers granted Congress by the thirteenth amendment.[54]

In view of these constitutional difficulties, a more desirable alternative may be to limit the scope of section 1981 to those contracts essential in maintaining the freedom guaranteed to blacks by the thirteenth amendment.[55] While this approach offers little in the way of tangible guidelines, it does have the advantage of providing the flexibility needed to determine with each new case whether the contract under review is necessary in maintaining the status of a free citizen. It may be observed, however, that those contracts dealing with employment,[56] property,[57] and the use

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dissenting in part and concurring in part). The dissent distinguished *Jones* by noting that, while it is necessary to compel whites to sell property to blacks, since otherwise there might be no other source from which blacks could purchase property, there is no such necessity with regard to education since "[t]he overwhelming portion of the burden of educating our people is borne by public schools, which by law are non-segregated." *Id.* at 1095–96.

53. For the text of the 1866 Act, *see* note 10 *supra.*

54. It should be noted that Congress' power under the thirteenth amendment is potentially very broad. It was held in the Civil Rights Cases, 109 U.S. 3 (1883), that it was limited to enacting legislation "for the obliteration and prevention of slavery with all its badges and incidents." *Id.* at 21. However, the *Jones* Court held that "Congress has the power . . . rationally to determine what are the badges and the incidents of slavery." 392 U.S. at 440. In light of this deference to the legislative judgment, it may be a rare occasion that the Supreme Court declares that Congress has exceeded its thirteenth amendment enforcement power.

55. The need for a statute to remedy the evils of slavery still existing after the passage of the thirteenth amendment can be aptly summarized as follows:

> Because the slave was a chattel he could not himself own anything, either other chattels or real property. Moreover, the slave could neither contract nor be contracted with. Since he could not enter into contracts, the slave could not have claims against others, and conversely, no one could have legal claims against him. He could neither sue nor be sued, nor could he inherit or devise property. And since marriage is a contract, the slave could not marry. In short, the slave was not a "person" in the contemplation of the law; he had no personal or "civil" rights. . . . [I]f these disabilities were to be imposed on the newly "freed" slave, his condition would not differ greatly from what it was prior to his emancipation.

Kohl, note 24 *supra,* at 275–76 (footnotes omitted).

The inability to purchase land seemed to have been the biggest detriment to the newly freed slave since "[w]ithout land, the black man was still bound to the white; with land, he could chart his own course. The white knew this, and he 'instinctively' refused to sell land to the black." *Id.* at 280.

56. There is evidence in the congressional debates that the right to contract for employment was intended by Congress to be secured by the 1866 Act. *See* CONG. GLOBE, 39th Cong., 1st Sess. 1833 (1866) (remarks of Representative Lawrence). In addition, several lower courts have held that section 1981 prohibits private discrimination in employment. *E.g.,* Brady v. Bristol-Meyers, Inc., 459 F.2d 621 (8th Cir. 1972); Brown v. Gaston County Dyeing Mach. Co., 457 F.2d 1377 (4th Cir.), *cert. denied,* 409 U.S. 982 (1972); Sanders v. Dobbs Houses, Inc., 431 F.2d 1097 (5th Cir. 1970), *cert. denied,* 401 U.S. 948 (1971); Waters v. Wisconsin Steel Works of Int'l Harvester Co., 427 F.2d 476 (7th Cir.), *cert. denied,* 400 U.S. 911 (1970); Dobbins v. Local 212, IBEW, 292 F. Supp. 413 (S.D. Ohio 1968). *But see* Smith v. North Am. Rockwell Corp., 50 F.R.D. 515 (N.D. Okla. 1970) (section 1981 not applicable to private discrimination in employment contracts).

57. *See* 42 U.S.C. § 1982 (1970).

of hotels, restaurants, and transportation facilities[58] would generally be includable under this approach, while those contracts which are at most tenuously related to maintaining freedom — *e.g.,* access to theatres and private clubs[59] — would generally be excluded. Since education has been recognized as having special significance in maintaining freedom,[60] it would seem that section 1981 would encompass contracts of that nature.

Although section 1981, as construed by the *McCrary* majority, grants to blacks the right to be free from discrimination in admission to private schools, the interests of the white students in free association cannot be unduly impaired. Freedom of association, as correctly pointed out by the *McCrary* court,[61] has traditionally been defined as ancillary to freedom of speech.[62] However, since the Supreme Court has dealt with associational rights primarily in terms of those groups engaged in "the advancement of beliefs and ideas,"[63] the question has been left open as to whether or not members of an organization which does not engage in such advocacy come within the protection of the first amendment[64] on the basis that membership in the organization is, in itself, an expression of approval of the group's activities. Thus, although the *McCrary* court found *NAACP v. Alabama*[65] to be controlling on this issue,[66] that case did not foreclose the issue as to

58. Senator Trumbull, the sponsor of the 1866 Act, indicated that the right to "go and come at pleasure" would be secured by the statute. CONG. REC., 39th Cong., 1st Sess. 43 (1866) (remarks of Senator Trumbull). Presumably, such a right would also include the means of effectuating it, *e.g.,* access to travel accommodations.

59. Had the *McCrary* court analyzed section 1981 in this way, it would have been faced with the additional problem of reconciling *Tillman* with this analysis. *See* notes 30–32 and accompanying text *supra.* It is at best questionable whether the right to be a guest at an all white recreational center, which the Court characterized as a right to contract, is within the class of contracts which were intended to insure that blacks would forever remain free. Since, however, the framers of the 1866 Act specifically singled out the right to buy and sell property from the other contract rights, *see* note 11 *supra,* it is arguable that they intended that *any* property right is so fundamental that it must be safeguarded in order to guarantee for blacks the freedom afforded by the thirteenth amendment. Further, since the right to be a guest at a swimming pool is a right to access to property, it is at least arguable that the guest in *Tillman* was merely being afforded his right to freedom within the meaning of the 1866 Act.

60. Professor Larson has stated that education is a crucial element in the law of race relations, hypothesizing that blacks "live in a poorer housing area, because in turn they have poorer jobs, because in turn they have poorer education." Larson, *The New Law of Race Relations,* 1969 WISC. L. REV. 470, 473. He viewed education, employment, and housing as so interrelated that the black's problems could not be solved except by confronting all three of these areas of concern. *Id.*

61. *See* notes 42–43 and accompanying text *supra.*

62. NAACP v. Alabama, 357 U.S. 449 (1958).

63. *Id.* at 460. Most cases dealing with freedom of association have involved groups whose primary purpose was political expression. *See, e.g.,* Elfbrandt v. Russell, 384 U.S. 11 (1966); NAACP v. Alabama, 357 U.S. 449 (1958). *See generally* Comment, *Discrimination in Private Social Clubs: Freedom of Association and Right to Privacy,* 1970 DUKE L.J. 1181, 1190–1200.

64. *See* Comment, note 65 *supra,* at 1202.

65. 357 U.S. 449 (1958).

66. *See* notes 42 & 43 and accompanying text *supra.*

whether or not freedom of association is limited to the situation of group advocacy.[67] Indeed, there is dicta in other cases to the effect that simply banding together is a protected associational right.[68]

Even if an associational right could be found in this case, the question would have to be confronted as to whether or not there would be an interest sufficient to override that right.[69] Since the government has an interest in insuring equal treatment of all citizens regardless of race,[70] that interest may override the students' associational rights, especially since, as the *McCrary* court pointed out, the schools would not be prohibited from promulgating any ideas or theories.[71]

Some commentators have submitted that the right of privacy, and not the right of association, is involved in dealing with desegregation cases.[72] The right of privacy is predicated on the belief that at some point an individual's activities should be free from governmental interference,[73] while on the other hand a person should not be heard to complain if there is interference with an activity which he has in effect made public.[74] This right has been dealt with only in terms of the most intimate relationships,[75]

67. It is interesting to note that the portion of *NAACP v. Alabama* relied upon by the *McCrary* court does not limit the right of association to the area protected by freedom of speech but merely underscores the relationship between the two. *See* note 43 *supra*.

68. The Supreme Court has stated that "[t]he right of 'association,' . . . includes the right to express one's attitudes or philosophies by membership in a group or by affiliation with it or by other lawful means." Griswold v. Connecticut, 381 U.S. 479, 483 (1965); *see* Moose Lodge No. 107 v. Irvis, 407 U.S. 163, 179 (1972) (Douglas, J., dissenting) ("The associational rights which our system honors permit all white, all black, all brown, and all yellow clubs to be formed.").

69. *See, e.g.*, Communist Party v. Subversive Activities Control Bd., 367 U.S. 1, 91 (1961).

70. U.S. CONST. amend. XIV.

71. *See* notes 44 & 45 and accompanying text *supra*.

72.

> The right of the government to *compel* personal associations, as by forbidding racial discrimination in schools . . . is surely not subject to resolution in terms of a blanket right of association or non-association. Rather such problems . . . must be framed in terms of drawing the line between the public and private sectors of our common life. The question is, in short, one of the right of privacy . . . .

Emerson, *Freedom of Association and Freedom of Expression*, 74 YALE L.J. 1, 20 (1964) (emphasis in original). *But see* Henkin, *Privacy and Autonomy*, 74 COLUM. L. REV. 1410, 1420 (1974) (freedom of association includes the right not to associate).

73. *See* Henkin, note 72 *supra*, at 1413.

74. Such a rationale has been used in cases dealing with the right of privacy, where it has been held that an inherently private activity divests itself from immunity from government interference when it is conducted in a public manner. *See, e.g.*, Wishart v. McDonald, 500 F.2d 1110 (1st Cir. 1974); Lovisi v. Slayton, 363 F. Supp. 620 (E.D. Va. 1973); Harris v. United States, 315 A.2d 569 (D.C. Ct. App. 1974).

75. The Supreme Court has recognized a right of privacy with respect to the use of contraceptives, Griswold v. Connecticut, 381 U.S. 479 (1965), obtaining an abortion, Roe v. Wade, 410 U.S. 113 (1973), possessing obscene materials in the home, Stanley v. Georgia, 394 U.S. 557 (1969), and freedom from electronic surveillance, Katz v. United States, 389 U.S. 347 (1967). For a survey of cases dealing with the right of privacy, *see* Comment, *The Constitutional Right of Privacy: An Examination*, 69 NW. U.L. REV. 263 (1974).

although it appears that it may be extended further.[76] Indeed, the majority in *McCrary* seemed to suggest that the right of privacy might require constitutional tolerance of segregated schools in some limited circumstances.[77]

Perhaps, however, neither the right of privacy nor freedom of association is an appropriate matter for consideration when dealing with section 1981. Since, of necessity, badges and incidents of slavery must be involved in any section 1981 action,[78] it is arguable that any rights secured thereunder are always superior. If this analysis is accepted, the impact of *McCrary* will be to proscribe racial discrimination in virtually every aspect of life.

However, if the privacy limitation which the *McCrary* court placed upon section 1981 has validity, the least that *McCrary* holds is, not that section 1981 prohibits segregation in private schools, but that the schools involved in *McCrary* were not truly "private."[79] Viewed in this light, *McCrary* may be a small but significant step in formulating a workable definition of privacy.

On the other hand, *McCrary* may be read as standing for the broader proposition that no school whose enrollment is not limited to the immediate family[80] can be truly private,[81] and thus cannot escape the grasp of section 1981. If construed in this way, *McCrary* is a great step forward for the civil rights movement. Following the landmark cases of *Brown v. Board of Education*[82] and *Green v. New Kent County School Board*,[83] many

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76. The Supreme Court has not clearly defined the scope of the right of privacy. The only clear limitation that has been placed on this right is that an activity which normally would fall within its scope may lose its immunity from governmental interference if it is conducted in a public manner. *See* note 74 *supra.*

However, the rationale of the Supreme Court in Griswold v. Connecticut, 381 U.S. 479 (1965), and Roe v. Wade, 410 U.S. 113 (1973), might militate against an expanded concept of privacy. In *Griswold,* the Court was concerned with the repugnancy of police enforcement of a ban against contraceptives, 381 U.S. at 485, while in *Wade,* the Court emphasized the magnitude of the physical and mental harm that the state would impose upon a woman who was prohibited from obtaining an abortion, 410 U.S. at 153. *See* Comment, note 75 *supra,* at 277.

77. *See* note 48 *supra.*

78. *See* note 54 *supra.*

79. 515 F.2d at 1089. *See also* note 48 and accompanying text *supra.*

80. *See* note 48 *supra.*

81. 515 F.2d at 1088–89. This proposition is illustrated by the following quote:

> In a country dedicated to the creed that education is the only "sure foundation * * of freedom," "without which no republic can maintain itself in strength," institutions of learning are not things of purely private concern.

Guillory v. Administrators of Tulane Univ., 203 F. Supp. 855, 858 (E.D. La.), *new trial granted,* (unreported opinion, E.D. La.), *aff'd,* 306 F.2d 489 (5th Cir. 1962) (footnotes omitted), *quoting* Letter from Thomas Jefferson to George Whythe, Aug. 13, 1786, in 5 WRITINGS OF THOMAS JEFFERSON 396 (A. Lipscomb & A. Bergh eds. 1907) *and* Letter from Thomas Jefferson to Governor John Tyler, May 26, 1810, in 12 WRITINGS OF THOMAS JEFFERSON 393 (A. Lipscomb & A. Bergh eds. 1907).

82. 347 U.S. 483 (1954). *Brown* held that racial segregation in public schools was proscribed by the equal protection clause of the fourteenth amendment. *Id.* at 495.

83. 391 U.S. 430 (1968). *Green* took the *Brown* ruling one step further by holding that the state has an affirmative duty to desegregate its schools. *Id.* at 437–38.

white pupils, especially in the South, flocked to private schools in order that they might isolate themselves from such forced interaction.[84] Until the *McCrary* decision, this mass exodus remained a "significant threat to the existence of an effective system of desegregated public education in much of the South."[85] The impact of the *McCrary* decision, therefore, may not only be to allow blacks to be educated in previously all-white private schools but it may also have a reflex effect of achieving true desegregation in the public school systems.

Joseph S. Bodoff

CONSTITUTIONAL LAW — PROCEDURAL DUE PROCESS — BOND REQUIREMENTS IMPOSED UPON PLAINTIFFS SUING PUBLIC ENTITIES HELD TO VIOLATE DUE PROCESS WHEN NO PRIOR HEARING IS PROVIDED TO DETERMINE NECESSITY OR REASONABLENESS OF BOND.

Beaudreau v. Superior Court (Cal. 1975)

Plaintiffs, a group of students and parents, brought an action against a school district and certain of its employees.[1] Defendants demanded that plaintiffs post undertakings as security for costs pursuant to sections 947[2] and 951[3] of the California Government Code, which permit public entities

84. Note, note 7 *supra,* at 1441.
85. *Id.* at 1440.

1. Beaudreau v. Superior Court, 14 Cal. 3d 448, 535 P.2d 713, 121 Cal. Rptr. 585 (1975). Plaintiffs alleged a deprivation of rights in violation of the Elementary and Secondary Education Act of 1965, 20 U.S.C. §§ 241 *et seq.* (1970). Since the instant case involved a pretrial challenge to the bond requirement, the merits of the plaintiffs' claim under these statutes were not addressed by the court.

2. CAL. GOV'T CODE § 947(a) (West 1966). Section 947(a) provides in pertinent part:

> At any time after the filing of the complaint in any action against a public entity, the public entity may file and serve a demand for a written undertaking on the part of each plaintiff as security for the allowable costs which may be awarded against such plaintiff. The undertaking shall be in the amount of one hundred dollars ($100) for each plaintiff or in the case of multiple plaintiffs in the amount of two hundred dollars ($200) or such greater sum as the court shall fix upon good cause shown, with at least two sufficient sureties, to be approved by the court. Unless the plaintiff files such undertaking within 20 days after service of a demand therefor, his action shall be dismissed.

Id.

3. *Id.* § 951(a). Section 951(a) provides in pertinent part:

> At any time after the filing of the complaint in any action against a public employee or former public employee, if a public entity undertakes to provide for the defense of the action, the attorney for the public employee may file and serve a demand for a written undertaking on the part of each plaintiff as security for the allowable costs which may be awarded against such plaintiff. The undertaking shall be in the amount of one hundred dollars ($100), or such greater sum as the court shall fix upon good cause shown, with at least two sufficient sureties, to be approved by the court. Unless the plaintiff files such undertaking within 20 days after service of the demand therefor, his action shall be dismissed.

Id.

and public employees to make a demand for undertakings without a prior court order in any action brought against them.[4]

Upon plaintiffs' motion to quash defendants' demands, the trial court upheld sections 947 and 951 against due process and equal protection attacks,[5] reduced the amount demanded, and ordered the filing of the reduced demand within 20 days upon penalty of dismissal.[6] Upon plaintiffs' petition for relief,[7] the Supreme Court of California reversed, *holding* the statutes which required plaintiffs to post, upon a defendant's demand, a written undertaking as security for allowable costs in actions filed against public entities or employees deprived plaintiffs of property without due process of law because the statutes failed to provide for a prior hearing with regard to the merits of a plaintiff's case, the necessity of an undertaking, or its reasonableness. *Beaudreau v. Superior Court,* 14 Cal. 3d 448, 535 P.2d 713, 121 Cal. Rptr. 585 (1975).

Prior to its consideration of sections 947 and 951[8] in *Beaudreau,* the California Supreme Court in *Brooks v. Small Claims Court*[9] had held an analogous statutory requirement that appellants post a bond for costs before

4. 14 Cal. 3d at 451, 535 P.2d at 714, 121 Cal. Rptr. at 586.

5. The fourteenth amendment provides in pertinent part:

> [N]or shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.

U.S. CONST. amend. XIV.

6. 14 Cal. 3d at 451–52, 535 P.2d at 714, 121 Cal. Rptr. at 586. Defendants had served seven documents upon plaintiffs demanding undertakings in amounts totaling $25,700. The trial court reduced this amount to $20,900 after determining the original demand to be in excess of statutory limitations absent a showing of good cause. *Id.*

7. *Id.* at 451, 535 P.2d at 714, 121 Cal. Rptr. at 586. The plaintiffs abandoned the equal protection argument in their petition and sought relief solely upon the alleged denial of due process. *Id.*

8. For the text of these sections, *see* notes 2 & 3 *supra.* By enacting these statutes requiring plaintiffs to file an undertaking in any action against a public entity or employee, the California legislature apparently intended to deter frivolous suits. 14 Cal. 3d at 452–53, 535 P.2d at 715, 121 Cal. Rptr. at 587. The court noted that although the purpose underlying the statute was to protect public entities, the legislature did not intend to place an unreasonable burden upon plaintiffs with meritorious claims. *Id.* at n.6.

Sections 947 and 951 were enacted as part of a comprehensive statutory scheme to control government tort liability. *See* CAL. GOV'T CODE §§ 810 *et seq.* (West 1966). The statutory design was, in part, a response to the judicial abrogation of governmental immunity pronounced by the California Supreme Court in Muskopf v. Corning Hosp. Dist., 55 Cal. 2d 211, 359 P.2d 457, 11 Cal. Rptr. 89 (1961). In response to *Muskopf,* the state legislature enacted a "moratorium" which stayed the effect of *Muskopf* until the spring of 1963 when the present scheme of governmental tort liability became effective. Law of Sept. 15, 1961, ch. 1404, § 1, [1961] Cal. Laws 22.3 (expired 1963). In essence, the legislation provides for complete governmental immunity, absent express statutory waiver. Sava v. Fuller, 249 Cal. App. 2d 281, 57 Cal. Rptr. 312 (1967). In *Sava,* the court explained that "by section 815 [of the California Government Code,] immunity becomes the rule, and we must look to the sections of the act following that section for exceptions." *Id.* at 284, 57 Cal. Rptr. at 313. For extensive analysis of the available avenues of relief under these statutes, *see* Comment, *Our Sufferance is a Gain to Them: An Analysis of the Constitutionality of California's Scheme for Suing the Government in Tort,* 8 U. SAN FRAN. L. REV. 611 (1974).

9. 8 Cal. 3d 661, 504 P.2d 1249, 105 Cal. Rptr. 785 (1973).

appealing the adverse decision of a small claims court to violate due process. Stating that the landmark decisions of *Sniadach v. Family Finance Corp.*[10] and *Fuentes v. Shevin*[11] had expanded the development of the constitutional right of due process to include ex parte seizures of property without procedural safeguards,[12] the *Brooks* court noted that California had, as a result of these decisions, struck down various ex parte summary procedures as violative of due process.[13] Analogizing a bond requirement to the seizures by creditors in *Sniadach* and *Fuentes,* the *Brooks* court reasoned that in both situations the ex parte demand had resulted in a taking of property, and that even if the taking were only temporary, interim deprivations of property had become firmly imbedded in the due process calculus.[14] Thus, by extending the reach of the *Sniadach-Fuentes* rationale to the *Brooks* situation, the California Supreme Court had established a substantial precedent for the *Beaudreau* decision.

The *Beaudreau* court first considered the purpose and function of sections 947 and 951, noting that although these statutes purported to deter unmeritorious litigation, they applied to all claims against a public entity, regardless of merit.[15] The court observed that if a defendant limited his demand to the amount automatically allowed by statute,[16] no prior or subsequent judicial approval was required.[17] Further, the court noted that defendants in an ex parte proceeding could, if good cause were shown, have the court fix undertakings in greater amounts.[18] The court determined that unless the plaintiff were indigent,[19] failure to meet either the

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10. 395 U.S. 337 (1969).

11. 407 U.S. 67 (1972).

12. 8 Cal. 3d at 666, 504 P.2d at 1252, 105 Cal. Rptr. at 788; *see* Note, *Garnishment of Wages Prior to Judgment is a Denial of Due Process: The* Sniadach *Case and Its Implications for Related Areas of the Law,* 68 MICH. L. REV. 986 (1970); Note, *Quasi in Rem Jurisdiction and Due Process Requirements,* 82 YALE L.J. 1023 (1973).

13. The California progeny of the *Sniadach* rationale include Randone v. Appellate Dep't, 5 Cal. 3d 536, 488 P.2d 13, 96 Cal. Rptr. 709 (1971) (invalidating prejudgment attachment procedure); Blair v. Pitchess, 5 Cal. 3d 258, 486 P.2d 1242, 96 Cal. Rptr. 42 (1971) (invalidating prejudgment replevin claim and delivery remedy); Cline v. Credit Bureau, 1 Cal. 3d 908, 464 P.2d 125, 83 Cal. Rptr. 669 (1970) (invalidating prejudgment wage garnishment procedure); McCallop v. Carberry, 1 Cal. 3d 903, 464 P.2d 122, 83 Cal. Rptr. 666 (1970) (invalidating prejudgment attachment of wages). Although affirming the proposition that an individual must be afforded notice and an opportunity for a hearing before he is deprived of any significant property interest, these cases left intact the exception announced by *Sniadach* for extraordinary circumstances. *See* 395 U.S. at 339.

14. 8 Cal. 3d at 667, 504 P.2d at 1253, 105 Cal. Rptr. at 789; *see* Fuentes v. Shevin, 407 U.S. 67 (1972); Sniadach v. Family Fin. Corp., 395 U.S. 337 (1968).

15. 14 Cal. 3d at 453, 535 P.2d at 715, 121 Cal. Rptr. at 587.

16. *See* notes 2 & 3 *supra.*

17. 14 Cal. 3d at 453, 535 P.2d at 716, 121 Cal. Rptr. at 588.

18. *Id.* at 453–54, 535 P.2d at 716, 121 Cal. Rptr. at 588.

19. *Id.* The court pointed out that plaintiffs qualifying to proceed in forma pauperis might be relieved from the undertaking requirement. *Id; see* Conover v. Hall, 11 Cal. 3d 842, 523 P.2d 682, 114 Cal. Rptr. 642 (1974); County of Sutter v. Superior Court, 244 Cal. App. 2d 770, 53 Cal. Rptr. 424 (1966). In *Brooks,* the

defendant's statutory demand, or one fixed after a showing of good cause, would result in dismissal of plaintiff's action.[20] The court then recognized that California had consistently struck down similar summary procedures[21] since the Supreme Court's landmark decision in *Sniadach*.[22] Applying the *Sniadach* rationale, and also its own decision in *Brooks*, the court reasoned that an undertaking requirement could result in a denial of due process by temporarily depriving the plaintiff of the funds used for the bond.[23] The court held, therefore, that the statutes required an unconstitutional taking of property if the plaintiff complied with the statute by filing the undertaking.[24]

The court also concluded that the statutes allowed an unconstitutional deprivation of property where the plaintiff refused to file the undertaking and incurred a dismissal of his action.[25] Relying principally upon *Board of Regents v. Roth*,[26] the court stated that a meritorious action against a public entity or employee was a "legitimate claim of entitlement"[27] and therefore was a protected property interest.

Having concluded that sections 947 and 951 effectuated a dual taking of property, the court's analysis shifted to the issue of what process was due the plaintiffs. The court noted that, although formality and procedural requisites could vary,[28] some form of appropriate notice and meaningful hearing was required[29] before the plaintiff could be deprived of the property interest.[30] Under the instant facts, the court determined that a meaningful hearing would require inquiry into whether the statutory purpose was promoted by the imposition of the undertaking requirement.[31] The focus of the inquiry should be upon a determination of the meritorious nature

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California Supreme Court found that it was immaterial whether a person could afford the deprivation of his property, stating that a denial of due process affects the rich as well as the poor. 8 Cal. 3d at 670, 504 P.2d at 1255, 105 Cal. Rptr. at 791.

20. 14 Cal. 3d at 454, 535 P.2d at 716, 121 Cal. Rptr. at 588.

21. *See* note 12 *supra*.

22. 14 Cal. 3d at 455, 535 P.2d at 716, 121 Cal. Rptr. at 589.

23. 14 Cal. 3d at 456, 535 P.2d at 717, 121 Cal. Rptr. at 589. The court further stated that if a corporate surety was used, plaintiffs would suffer a deprivation of the nonrefundable premium. *Id.*

24. *Id.*

25. *Id.*

26. 408 U.S. 564 (1972). In *Roth*, the Court held that a nontenured teacher had no property interest in reemployment following the expiration of his 1 year contract, and therefore no due process hearing was mandated when he was not rehired. In so concluding, the Court asserted that the fourteenth amendment protects only those property interests to which the individual has "a legitimate claim of entitlement." *Id.* at 577.

27. 14 Cal. 3d at 457, 535 P.2d at 718, 121 Cal. Rptr. at 590.

28. *Id.* at 458, 535 P.2d at 719, 121 Cal. Rptr. at 591, *citing* Boddie v. Connecticut, 401 U.S. 371, 378 (1971).

29. 14 Cal. 3d at 458, 535 P.2d at 719, 121 Cal. Rptr. at 591, *citing* Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306 (1950).

30. 14 Cal. 3d at 458, 535 P.2d at 719, 121 Cal. Rptr. at 591, *citing* Brooks v. Small Claims Court, 8 Cal. 3d 661, 504 P.2d 1249, 105 Cal. Rptr. 785 (1973).

31. 14 Cal. 3d at 460, 535 P.2d at 720, 121 Cal. Rptr. at 592.

of the action as well as the necessity and reasonableness of the undertaking to protect and reimburse the defendant.[32]

The court concluded by rejecting the defendants' remaining arguments. First, the court declined to distinguish between "rights" and "privileges," in response to the defendants' contention that, as a "privilege," the ability to bring an action against a public entity could be made conditional.[33] The court also dismissed defendants' argument that a similar bond requirement, imposed in shareholders' derivative suits, had been upheld as constitutional[34] since the relevant statute contained notice and hearing provisions.[35] Finally, although the defendants' urged that the Supreme Court had retreated from the *Sniadach-Fuentes* rationale in recent decisions,[36] the court stated that this rationale had been reaffirmed[37] in *North Georgia Finishing, Inc. v. Di-Chem, Inc.*,[38] which invalidated a garnishment statute, and in *Goss v. Lopez*,[39] which held that high school students facing temporary suspensions from public schools had a protected property interest under the due process clause.

In *Beaudreau,* the property interests were twofold: the use of the undertaking funds and the maintenance of a claim against a public entity or its employees.[40] The *Beaudreau* court found a due process violation

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32. *Id.*

33. *Id.* at 461, 535 P.2d at 721, 121 Cal. Rptr. at 593. The concept that constitutional rights are contingent upon characterization of a governmental benefit as a "right" or "privilege" has been abrogated by the United States Supreme Court. Graham v. Richardson, 403 U.S. 365, 374 (1971); Goldberg v. Kelly, 397 U.S. 254, 262 (1970).

34. Cohen v. Beneficial Loan Corp., 337 U.S. 541 (1949). For the text of the statute, *see* CAL. CORP. CODE § 834(b) (West 1955). Moreover, in *Cohen,* a shareholders derivative action, plaintiff did not raise the procedural due process issue.

35. 14 Cal. 3d at 462, 535 P.2d at 721–22, 121 Cal. Rptr. at 594.

36. *Id.* at 463–65, 535 P.2d at 722–24, 121 Cal. Rptr. at 594–96. Defendants contended that the rulings in Mitchell v. W.T. Grant Co., 416 U.S. 600 (1974) (upholding an ex parte sequestration creditor remedy), and in Arnett v. Kennedy, 416 U.S. 134 (1974) (holding a provision prohibiting removal without cause of nonprobationary governmental employees as not creating a protected expectancy in job retention), reduced the potency of the *Sniadach-Fuentes* rationale. 14 Cal. 3d at 463–65, 535 P.2d at 722–24, 121 Cal. Rptr. at 594–96.

37. The instant court held that even if such a retreat was occurring, the *Beaudreau* decision was supported under the California Constitution, CAL. CONST. art. 1, § 13, cl. 6. 14 Cal. 3d at 462–63, 535 P.2d at 722–23, 121 Cal. Rptr. at 594–95. Moreover, the *Beaudreau* court found that Mitchell v. W.T. Grant Co., 416 U.S. 600 (1974), and Arnett v. Kennedy, 416 U.S. 134 (1974), were factually distinguishable. Claiming that the *Grant* and *Arnett* statutes provided for pre-deprivation procedural safeguards, involved situations requiring prompt action, and permitted a prompt post-deprivation due process hearing, the *Beaudreau* court found those cases inapposite to the present case, which lacked such safeguards.

38. 419 U.S. 601 (1975).

39. 419 U.S. 565 (1975), *noted in* 20 VILL. L. REV. 1069 (1975).

40. 14 Cal. 3d at 456, 535 P.2d at 717, 121 Cal. Rptr. at 589.

through an application of the *Sniadach-Fuentes* rationale that a temporary deprivation of a property interest requires due process safeguards.[41] However, in doing so, the court deemphasized the requisite initial determination of whether the property was of a type protected by the due process clause. In making this determination, distinct property interests should receive differentiated due process analysis.[42] For example, when deciding whether procedural due process rights attached to a public employee's interest in continued employment, the Supreme Court in *Arnett v. Kennedy*[43] relied upon *Roth*,[44] and *Perry v. Sinderman*,[45] both of which dealt with the governmental employer-employee relationship and requirements regarding its termination. The *Arnett* Court rejected arguments that its decision should be guided by *Sniadach* or *Fuentes*, which, according to the *Arnett* Court, involved a separate sphere of due process.[46]

By injecting the *Sniadach-Fuentes* rationale into the facts of *Brooks* and the instant case, the California Supreme Court may have transplanted a fertile concept to a field requiring a different analytical seed. A review of the Supreme Court's decisions in *Sniadach, Fuentes,* and subsequent cases reveals that this line of cases primarily involved debtors' rights with regard to temporary deprivations of property affected by ex parte creditor remedies.[47] Although the demands by an appellee in *Brooks* and by the

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41. *Id.*

42. Arnett v. Kennedy, 416 U.S. 134, 154-55 (1974). In Cafeteria & Restaurant Workers v. McElroy, 367 U.S. 886 (1961), the Supreme Court noted that a due process analysis "must begin with a determination of the precise nature of the government function involved as well as of the private interest that has been affected." *Id.* at 895.

43. 416 U.S. 134 (1974).

44. *See* note 26 and accompanying text *supra.*

45. 408 U.S. 593 (1972) (a college teacher should be permitted to show a property interest in his continued employment by proving the existence of a de facto tenure system).

46. 416 U.S. at 154-55.

47. In *Sniadach,* the court struck down as violative of due process a statute which allowed garnishment of wages without notice and a prior hearing. 395 U.S. at 342. Replevin statutes were held unconstitutional upon similar grounds in *Fuentes.* 407 U.S. at 96. *Fuentes* was arguably "repossessed" 2 years later by Mitchell v. W.T. Grant Co., 416 U.S. 600 (1974), which upheld a Louisiana sequestration statute. *See* Newton and Timmons, *Fuentes "Repossessed,"* 26 BAYLOR L. REV. 469 (1974). In his concurring opinion in *Mitchell,* Justice Powell stated that "[t]he Court's decision today withdraws significantly from the full reach of the [*Fuentes*] principle, and to this extent I think it fair to say that the *Fuentes* opinion is overruled." 416 U.S. at 623 (Powell, J., concurring); *see id.* at 629 (Stewart, J., dissenting in part and concurring in part). However, in 1975, the Court either "resuscitated" *Fuentes* or narrowed the implications of *Mitchell* by deciding North Georgia Finishing, Inc. v. Di-Chem., Inc., 419 U.S. 601 (1975). The majority opinion limited the *Mitchell* holding to the situation where the seizure was preceded by a writ issued by a judge after affidavits were filed clearly showing facts entitling the creditor to sequestration, and where the debtor was entitled to an immediate hearing subsequent to the seizure in which the creditor had the burden of proof to uphold the sequestration order. *Id.* at 606-07.

In the California progeny of *Sniadach,* the California Supreme Court solely addressed the problem of ex parte seizures of debtors' property by creditors. *See* cases cited in note 13 *supra.*

defendants in *Beaudreau* were ex parte, there was no accompanying *seizure* of property, which arguably constituted the sine qua non of the *Sniadach-Fuentes* rationale.[48] Rather, the result of the ex parte proceeding in *Beaudreau* was an undertaking demand upon penalty of dismissal.[49]

Although the foregoing strongly suggests that the *Sniadach-Fuentes* analysis was inapposite, other arguments are supportive of the court's approach. The taking in *Beaudreau,* like the seizures in *Sniadach* and *Fuentes,* benefited one party to the detriment of the other. Furthermore, by analogy, the taking of the plaintiffs' cause of action in *Beaudreau* for failure to post the undertaking was similar to the seizure of the debtor's property in *Sniadach* and *Fuentes* and the temporary deprivation of the undertaking funds resembled the interim deprivations of property in *Sniadach* and *Fuentes.* Hence, the only substantive distinction between *Sniadach* and *Beaudreau* was with regard to the nature of the property interests involved. However, it is precisely this distinction that arguably should determine the nature of the application of due process, since, as has been stated, different property interests necessitate individualized due process analysis.

The second taking aspect found by the court was the potential dismissal of the action for failure to file the undertaking. The court stated: "A meritorious action against a public entity or public employee clearly connotes a 'legitimate claim of entitlement' within the meaning of *Roth.*"[50] It is submitted, that the legitimate claim of entitlement to which the court referred,[51] may be described more accurately as a person's right-of-access to the courts. Both the undertaking requirement in the instant case and the appeal bond in *Brooks* created obstacles in the path of such access and arguably should have been subject to scrutiny on the basis of whether such obstacles created constitutionally impermissible burdens upon the parties involved.[52] The *Beaudreau* court, however, based its decision regarding both alleged taking aspects upon the *Sniadach-Fuentes* rationale.[53]

Doctrinal analysis respecting the right of access could be cast in terms of due process.[54] Under this approach the *Sniadach-Fuentes* rationale

48. *But cf.* Comment, *The Heirs of* Boddie: *Court Access for Indigents After* Kras *and* Ortwein, 8 HARV. CIV. RIGHTS-CIV. LIB. L. REV. 571 (1973).

49. *See* notes 2 & 3 *supra.*

50. 14 Cal. 3d at 457, 535 P.2d at 718, 121 Cal. Rptr. at 590, *quoting* 408 U.S. at 577.

51. *Id.* at 455, 535 P.2d at 717, 121 Cal. Rptr. at 589.

52. *See* Driscoll v. Plymouth Twp., 13 Pa. Cmwlth. 404, 320 A.2d 444 (1974) (holding a constitutional challenge of an appeal bond to a zoning hearing to stand or fall under a right-of-access analysis).

53. 14 Cal. 3d 448, 535 P.2d 713, 121 Cal. Rptr. 585 (1975).

54. The right of access has been recently treated with fifth and fourteenth amendment due process approaches in Ortwein v. Schwab, 410 U.S. 656, *reh. denied,* 411 U.S. 922 (1973); United States v. Kras, 409 U.S. 434 (1973); and Boddie v. Connecticut, 401 U.S. 371 (1971). In *Boddie,* the Court found required filing and service-of-process fees violative of the fourteenth amendment due process rights of indigent divorce plaintiffs. *Id.* at 382.

would be inapposite, since it applies to issues of procedural due process and not to problems involving substantive rights such as the access right.[55] If the court had adopted the right-of-access analysis, this would have led to an inquiry of whether the undertaking requirement contravened the substantive right-of-access per se, rather than whether the requirement caused a taking of property necessitating prior procedural safeguards. Such an inquiry may have led the court to uphold the bond requirement.[56]

However, the court may have avoided the right-of-access approach due to the lack of precedent for application of that proposition in factual settings not involving indigents.[57] Furthermore, the *Sniadach-Fuentes* approach afforded the further benefit of permitting the court to tailor a type of hearing in accord with the statutes' legislative purpose, by ensuring that the merits of plaintiffs' claim, as well as the reciprocal questions regarding the necessity and reasonableness of any undertaking, be the focus of the due process hearing.[58]

However, since the *Beaudreau* court did not further elaborate on what process is due, both practitioners and legislators are left to speculate as to the exact type of procedure which would satisfy this mandate. Standards and procedures to be applied in these hearings may have to be developed on a case-by-case basis, depending upon the exact substantive claim alleged. Unlike the ordinary debtor-creditor situation where a meaningful hearing simply focuses upon a single inquiry, *i.e.,* the debtor's defenses to the creditor's action,[59] a *Beaudreau*-type hearing would necessarily be more

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55. The *Boddie* Court did not rely upon the *Sniadach* "taking" analysis, but rather, viewed this right as substantive. 401 U.S. at 382–83.

56. It is submitted that this doctrinal approach should have been addressed by the *Beaudreau* court, since the *Beaudreau* plaintiffs arguably had a substantive right of access to the courts as well as the procedural right not to be denied such access without a hearing. The problem with this approach is twofold. First, subsequent Supreme Court decisions may have limited *Boddie*'s application to cases where the obstacle to court-access involves an "exclusive precondition" or a "fundamental relationship." *See* Ortwein v. Schwab, 410 U.S. 656, *reh. denied,* 411 U.S. 972 (1973) (upholding fee requirements as applied to indigents seeking to appeal welfare agency decisions); United States v. Kras, 409 U.S. 434 (1973) (upholding fee requirements against indigents seeking discharges in bankruptcy); Comment, *supra* note 48. Secondly, the right-of-access approach has apparently been restricted to cases involving indigents. The *Beaudreau* plaintiffs had available the in forma pauperis procedure, so indigent access was not in issue. *See* note 19 *supra.* Hence, it is submitted that, since the *Beaudreau* plaintiffs did not assert a fundamental relationship and since they did not proceed as indigents, the *Beaudreau* court would have had to uphold the bond requirement under the right-of-access analysis.

The right-of-access issue could also be raised under the first amendment. *See generally* Note, *A First Amendment Right of Access to the Courts for Indigents,* 82 YALE L.J. 1055 (1973). The benefit of this approach would be to anchor the access right to a specific constitutional safeguard, thereby placing a heavier burden of justification upon governmental restrictions. *Id.* at 1071.

57. *See* note 55 *supra.*

58. 14 Cal. 3d at 460, 535 P.2d at 720, 121 Cal. Rptr. at 592 (1975). Any hearing on the merits obviously would further the statutory intent by weeding out frivolous and unmeritorious claims.

59. Sniadach v. Family Fin. Corp., 395 U.S. 337, 339 (1969); Fuentes v. Shevin, 407 U.S. 67, 81 (1972).

problematic. The formulation of procedural standards, as proposed by *Beaudreau,* would involve a twofold inquiry, taking into account both the reasonableness of the undertaking and the nonfrivolous nature of the claim.

Whether a protracted inquiry into a plaintiff's claim is now required remains unclear and perhaps will be a source of contention in future litigation. It is possible that the hearings will serve the purposes of the statute in that once a claim has been determined frivolous, it would be infrequent that a plaintiff would continue his action. Thus, depending upon the particular procedures which are developed, the *Beaudreau* court may have effectuated the aim of the statute to deter unmeritorious litigation while employing the tool of due process.

Practically, the *Beaudreau* decision may lead to future challenges of bond requirements by plaintiffs who, under various statutes, are required to post bonds after ex parte proceedings before they may maintain their actions. Statutory bond requirements in taxpayer actions, for temporary restraining orders, in shareholder actions,[60] in actions by nonresidents, and for appeal bonds[61] might all suffer from constitutional infirmity if the *Beaudreau* rationale is widely adopted.[62]

Furthermore, the reasoning in *Beaudreau* may have an impact upon the future use of the *Sniadach-Fuentes* rationale in other than creditor-debtor ex parte remedy situations. Specifically, *Brooks* and *Beaudreau* may have opened the courtroom doors to right-of-access claims, while utilizing a procedural due process approach in finding a protected property interest.

In conclusion, the *Beaudreau* decision furthers the firm stance of the present California Supreme Court against ex parte procedures involving alleged takings of property. Although this stance would have arguably been firmer if analyzed as a substantive right-of-access problem, the California Supreme Court should nevertheless be applauded for its novel application of the *Sniadach-Fuentes* rationale.

David E. Worby

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60. Cohen v. Beneficial Loan Corp., 337 U.S. 541 (1949); *see* note 34 *supra.*

61. *See* note 52 *supra.* For an analysis of the effects of *Beaudreau* upon other California statutorily required court bonds, *see* Comment, *Due Process and Security for Expense Statutes: An Analysis of California Statutes in Light of Recent Trends,* 7 PAC. L.J. 176 (1976).

62. If the *Beaudreau* analysis is adopted by other jurisdictions, this would require redrafting of statutes. *See* Comment, *supra* note 60. It appears difficult to limit the *Beaudreau* holding to the facts of the case, since all ex parte bond requirements suffer from the same constitutional infirmities which the Supreme Court of California emphasized in invalidating the statute in the instant case: denial of use of funds and the deprivation of a cause of action.

CONSTITUTIONAL LAW — SCHOOL BOARD POLICY REQUIRING CHILDREN OF PUBLIC SCHOOL TEACHERS TO ATTEND DESEGREGATED PUBLIC SCHOOLS RATHER THAN PRIVATE SEGREGATED SCHOOLS HELD NOT VIOLATIVE OF FIRST AMENDMENT FREEDOM OF ASSOCIATION OR FOURTEENTH AMENDMENT DUE PROCESS AND EQUAL PROTECTION.

Cook v. Hudson (5th Cir. 1975)

Prior to the beginning of the school term, the principal of a Mississippi public school refused to recommend three public school teachers for re-employment[1] since the teachers violated the terms of an unwritten school board policy that prohibited public school teachers from enrolling their own children in racially segregated schools.[2] Seeking reinstatement and ancillary relief, the teachers brought suit against the county board of education and other school officials,[3] challenging the constitutionality of both the policy itself and their dismissals pursuant thereto.[4] Specifically, plaintiffs argued two major theories of allegedly unconstitutional board action: 1) the board

1. Cook v. Hudson, 511 F.2d 744 (5th Cir. 1975), *cert. granted,* 44 U.S.L.W. 4246 (U.S. March 2, 1976) (No. 75-503). Under Mississippi law, reemployment of teachers involves a two-step recommendation process. First, the school principal recommends teachers to the superintendent. Second, the superintendent recommends those teachers whom he approves to the school board. Since no tenure system exists in the State, each recommendation is critical in the decision to reemploy the teacher. Failure to obtain a recommendation results in the termination of employment upon the expiration of the prior contract. MISS. CODE ANN. § 37-9-17 (1972). For an application of Mississippi's statutory procedure in which the court refused to compel the school board to contract with a teacher, *see* Jennings v. Meridian Municipal Separate School Dist., 337 F. Supp. 567 (S.D. Miss.), *aff'd,* 453 F.2d 413 (5th Cir. 1971).

2. 511 F.2d at 744. Although the board policy was never formally reduced to writing, testimony established that the policy adopted was as follows:

> Prior to the employment of a new teacher, or the reemployment of an existing teacher, the children of any such teacher, if living in Calhoun County, Mississippi, will be required to attend the public schools of Calhoun County or said teacher will not be employed or reemployed.

Id. at 746. At the time of the policy's enactment, the teachers' children attended Calhoun Academy, found by the lower court to be the only private school located in the county then or in preceding years and thus, the prime target of the board's policy. *Id.*

3. Cook v. Hudson, 365 F. Supp. 855 (N.D. Miss. 1973). Federal court jurisdiction was exercised under 28 U.S.C. § 1343(3) (1970). The teachers, alleging an unconstitutional deprivation of their rights, based their claim for relief upon 42 U.S.C. § 1983 (1970).

4. 365 F. Supp. at 856, 858. In 1968, after a court-ordered "freedom of choice" plan fell short of achieving true desegregation, the district court directed the county school officials to act affirmatively to transform the dual system into a unitary school system by, *inter alia,* taking proper care in selecting and dismissing faculty. *Id.* at 856. The adoption of the policy was motivated by the board's endeavor to comply with the 1968 order. It embodied the board's fear that allowing public school teachers to enroll their children in private schools would necessarily subject the teachers to divided loyalties where absolute dedication was desirable. More importantly, the board felt that the black students would suffer a decrease in their learning ability upon perceiving the teachers' prejudice against integrated schools. *Id.* at 860. For a more extensive development of the general background in *Cook, see id.* at 856.

policy infringed their first amendment[5] right to select the school in which to educate their children, and 2) the policy violated the fourteenth amendment[6] as an arbitrary and capricious regulation.[7] Defendants asserted in response the absence of viable first amendment rights in the teachers' continuing employment and the rationality of the board policy under traditional equal protection scrutiny.[8] The United States District Court for the Northern District of Mississippi dismissed the complaint and upheld the board policy, finding its enactment to have been justified by the board's paramount educational interest in achieving integration, despite the policy's impingement upon the teachers' rights as parents.[9] Moreover, the court found the equal protection objections to be hurdled by discerning a rational relationship between the policy and several valid state objectives.[10]

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5. U.S. CONST. amend. I, § 1.

6. U.S. CONST amend. XIV, § 1.

7. 365 F. Supp. at 858.

8. *Id.* The United States Supreme Court has employed the doctrine of reasonable classification to test laws, ordinances, or policies for violations of the equal protection clause. Under this doctrine, often denominated "the rational relation test," the decisive questions are: 1) did the legislature or board have a constitutionally permissible purpose in taking its action, and 2) is the resultant classification reasonably related to accomplishing that purpose? The court need take only a cursory look at the nature of the classification, since it must assume the existence of any set of facts which can reasonably be conceived to sustain the law. *See* Dandridge v. Williams, 397 U.S. 471, 486–87 (1970). However, if the classification is labeled "suspect" or if it interferes with a "fundamental right," the Supreme Court has required a showing of a compelling state interest to justify the classification. *See* Shapiro v. Thompson, 394 U.S. 618, 634 (1969). *See generally Developments in the Law — Equal Protection,* 82 HARV. L. REV. 1065 (1969) [hereinafter cited as *Equal Protection*]. Chief Judge Keady of the district court asserted that the rational relation test was the proper standard by which to weigh the validity of the school board policy in *Cook.* 365 F. Supp. at 860.

9. 365 F. Supp. at 860. Chief Judge Keady also conveniently disposed of two additional claims, namely, that the regulation was overbroad and that it violated the procedural due process rights of the claimants by failing to afford them a hearing. With regard to the overbreadth issue, he easily construed the policy in the "limited terms intended by the board," thus avoiding a frontal constitutional attack, and expressed no opinion as to its potential applications to children attending schools other than Calhoun Academy. *Id.* at 859–60. He rejected the due process claim, stating that no hearing was necessary under the circumstances. *Id.* at 861, *citing* Perry v. Sindermann, 408 U.S. 593 (1972) (no requirement that a nontenured teacher be afforded a hearing unless the nonretention deprived the teacher of some interest in liberty or property protected by fourteenth amendment). Even conceding that a hearing was necessary, Chief Judge Keady observed that the teachers had received a full hearing at trial. 365 F. Supp. at 861.

10. 365 F. Supp. at 860. The rational relationship was established by the testimony of two educational psychologists who espoused the following concerns:

> [T]he challenged policy was significantly related to a teacher's effectiveness and job performance: students in desegregated classes are likely to perceive rejection, and experience a sense of inferiority, from a teacher whose own children attend a nearby racially segregated school, and be inclined to perform at a lower educational level.

Id. In addition to the state's interest in preserving teacher effectiveness, the district court also noted two other legitimate state interests served by the board policy: prevention of white flight from the school system and cultivation of teacher loyalty

On appeal, a divided[11] Court of Appeals for the Fifth Circuit affirmed, *holding* that the school board policy requiring the children of public school teachers to attend public schools and the non-renewal of the teachers' contracts for failure to comply with the policy did not violate the teachers' first amendment or fourteenth amendment rights. *Cook v. Hudson,* 511 F.2d 744 (5th Cir. 1975), *cert. granted,* 44 U.S.L.W. 4246 (U.S. March 2, 1976) (No. 75–503).

Along with other public employees, public school teachers had been excluded by the courts from the sweep of full constitutional protection by virtue of the right-privilege doctrine.[12] Under this doctrine, since public employment was a privilege which could be lawfully withheld, the state or its affiliated agencies could condition employment in any manner, even in derogation of the safeguards of the Bill of Rights.[13] Justice Holmes' blunt declaration in *McAuliffe v. Mayor of New Bedford,*[14] in 1892, epitomized the right-privilege distinction through which the judiciary viewed public employment for almost 80 years:[15] "the petitioner may have a constitutional right to talk politics, but he has no constitutional right to be a

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to the public schools. *Id.* For a complete and well-documented commentary on the district court opinion, *see* Comment, Cook v. Hudson: *State's Interest in Integration versus the First Amendment Rights of the Public Schoolteacher,* 45 MISS. L.J. 953 (1974).

11. Judges Coleman and Roney each filed separate opinions, with Judge Clark writing a per curiam preliminary statement and a separate dissenting opinion. A footnote to Judge Clark's dissenting opinion reveals that the dissent was originally written as a "proposed majority opinion to reverse the judgment of the district court." 511 F.2d at 750 n.1 (Clark, J., dissenting).

12. Ashe & DeWolfe, *Procedural Due Process and Labor Relations in Public Education: A Union Perspective,* 3 J. LAW & EDUC. 561, 561–63 (1974). Forced to chose between remaining employed and freely exercising constitutional rights, teachers often were induced to surrender their legitimate rights without remedy in the courts. Commentators have suggested that teachers may in fact have been forerunners in ameliorating the plight of the public servant and in paving the way for union members and others to challenge this narrowing of their constitutionally guaranteed rights. *Id.* at 612.

13. Bruff, *Unconstitutional Conditions upon Public Employment: New Departures in the Protection of First Amendment Rights,* 21 HASTINGS L.J. 129, 130 (1969). For applications of the right-privilege doctrine, *see* cases cited in note 15 *infra.*

14. 155 Mass. 216, 29 N.E. 517 (1892) (upholding a municipal police department rule prohibiting policemen from certain political involvement).

15. The 80-year span extended from 1882 to 1967, when the Supreme Court decided Keyishian v. Board of Regents, 385 U.S. 589 (1967). *See* note 21 *infra.* The key early decision which limited the freedoms of public servants by application of the right-privilege distinction was *Ex parte* Curtis, 106 U.S. 371 (1882). Justice Bradley's vigorous dissent in *Curtis, id.* at 376–77 (Bradley, J., dissenting), marked virtually the only time the right-privilege doctrine was disputed until 1947, when Justices Black, Douglas, and Rutledge dissented from the Supreme Court decision in United Public Workers v. Mitchell, 330 U.S. 75 (1947). *See* note 17 *infra.* For a case in which the Court of Appeals for the District of Columbia, applying a privilege doctrine rationale, readily upheld the dismissal of a federal employee on grounds of her association with certain "subversive" organizations, *see* Bailey v. Richardson, 182 F.2d 46 (D.C. Cir. 1950), *aff'd by an equally divided Court,* 341 U.S. 918 (1951). *See also* Garner v. Los Angeles Bd. of Pub. Works, 341 U.S. 716 (1951).

policeman."[16] Later United States Supreme Court decisions such as *United Public Workers v. Mitchell*[17] and *Adler v. Board of Education*[18] qualified the right-privilege theory by requiring only that any condition attached to employment be reasonable.[19] However, the years following the *Adler* decision saw the logic of these earlier privilege doctrine cases being rejected increasingly by the Supreme Court.[20]

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16. 155 Mass. at 220, 29 N.E. at 517.

17. 330 U.S. 75 (1947). In a 4–3 decision, the *Mitchell* Court upheld the Hatch Act, 5 U.S.C. §§ 7324 *et seq.* (1970), which prohibits active political work by civil service employees, on the grounds that imposition of this prohibition was a reasonable way in which to promote the efficiency and integrity of public service. 330 U.S. at 99. The Court's emphasis upon the reasonableness of the regulation indicated that the restrictions were tested under the due process rationality standard rather than under the stricter balancing scrutiny reserved for infringements of constitutionally guaranteed rights. *See id.* at 102–03. The Hatch Act was again upheld recently in United States Civil Serv. Comm'n v. National Ass'n of Letter Carriers, 413 U.S. 548 (1973). However, in the latter case, the statute survived a more stringent review by the Court, *i.e.*, the balancing test. *Id.* at 564; *see* Broaderick v. Oklahoma, 413 U.S. 603 (1973). In *Broaderick*, the companion case to *Letter Carriers*, the Supreme Court also upheld Oklahoma's statutory equivalent of the Hatch Act against a challenge by state employees. *Id.* at 556.

18. 342 U.S. 485 (1952). In *Adler*, the Supreme Court again couched in due process terms its holding that a New York statute barring employment to those who advocated violent overthrow of the government was a reasonable restriction. *Id.* at 492. *But see* Keyishian v. Board of Regents, 385 U.S. 589 (1967).

There is no agreement within the Supreme Court as to the precise status of *Adler*. *See* Keyishian v. Board of Regents, *supra* at 605, wherein Justice Brennan noted that the "constitutional doctrine which has emerged since [*Adler*] has rejected its major premise." *But see id.* at 625 (Clark, J., dissenting). *See generally* Grossman, *Public Employment and Free Speech: Can They be Reconciled?*, 24 AD. L. REV. 109 (1972); Palmer, *Due Process Termination of Untenured Teachers*, 1 J. LAW & EDUC. 469 (1972).

19. For an argument that the *Mitchell* rationality approach should be considered proper, *see* Grossman, *supra* note 18.

20. *See* Pickering v. Board of Educ., 391 U.S. 563, 568 (1968). In that case, the Supreme Court stated:

> To the extent that the [opinion below] may be read to suggest that teachers may constitutionally be compelled to relinquish the First Amendment rights they would otherwise enjoy as citizens . . . it proceeds on a premise that has been unequivocally rejected in numerous prior decisions of this Court.

Id. For prior decisions in which teachers challenged restrictions upon their constitutional rights and wherein the Court summarily rejected the privilege argument, *see, e.g.*, Baggett v. Bullett, 377 U.S. 360 (1964); Cramp v. Board of Pub. Instruction, 368 U.S. 278 (1961); Shelton v. Tucker, 364 U.S. 479 (1960); Speiser v. Randal, 357 U.S. 513 (1958); Slochower v. Board of Educ., 350 U.S. 551 (1956); Weiman v. Updegraff, 344 U.S. 183 (1952). For examples of similar cases outside the context of education, *see* Sherbert v. Verner, 374 U.S. 398 (1963); Torcaso v. Watkins, 367 U.S. 488 (1961).

Federal employees are indebted to Justice Douglas, who carried on their battle against second-class citizenship for 30 years. Van Alstyne, *The Constitutional Rights of Public Employees: A Comment on the Inappropriate Uses of an Old Analogy*, 16 U.C.L.A.L. REV. 751 (1969); *see* Barksy v. Board of Regents, 347 U.S. 442 (1953) where Justice Douglas, in a dissenting opinion stated:

> By the same reasoning a man has no constitutional right to teach, to work in a filling station, to be a grocery clerk, to mine coal, to tend a furnace, or to be

Today, full constitutional rights have been restored to public school teachers who no longer lose their constitutional rights solely by virtue of their employment in the public sector.[21] Likewise, it is axiomatic that even non-tenured teachers may not be deprived of a public position for constitutionally impermissible reasons.[22] Despite the demise of the absolute power

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on the assembly line. By that reasoning a man has no constitutional right to work.

. . . Man has indeed as much right to work as he has to live, to be free, to own property. . . .

The dictum of Holmes [in *McAuliffe*, 155 Mass. at 220, 29 N.E. at 517] gives a distortion to the Bill of Rights.

Id. at 472 (Douglas, J., dissenting).

The right-privilege distinction has been circumvented in several ways, notably by the doctrine of unconstitutional conditions which has been articulated thus:

[W]hatever an express constitutional provision forbids government to do directly it equally forbids government to do indirectly. As a consequence, it seems to follow that the first amendment forbids the government to condition its largess upon the willingness of the petitioner to surrender a right which he would otherwise be entitled to exercise as a private citizen.

Van Alstyne, *The Demise of the Right-Privilege Distinction in Constitutional Law*, 81 HARV. L. REV. 1439, 1445–46 (1968). This doctrine appeared frequently in law review material. *See generally* Note, *Unconstitutional Conditions*, 73 HARV. L. REV. 1595 (1960); Comment, *Constitutional Rights of Public Employees: Progress Toward Protection*, 49 N. CAR. L. REV. 302 (1971); Comment, *Another Look at Unconstitutional Conditions*, 117 U. PA. L. REV. 144 (1968) [hereinafter cited as *Another Look*]. For specific discussions of the doctrine of unconstitutional conditions as applied in situations other than the school system, *see* O'Neill, *Unconstitutional Conditions: Welfare Benefits with Strings Attached*, 54 CALIF. L. REV. 443 (1966); Willcox, *Invasions of the First Amendment Through Conditioned Public Spending*, 41 CORNELL L. REV. 12 (1955).

Another way in which the courts have avoided the harsh results generated by the right-privilege doctrine has been to recognize that teachers or governmental employees may have constitutionally protected interests in "liberty" and "property" by virtue of their employment. Due process of law must be accorded to the teacher if such a protected interest exists. *See* Perry v. Sindermann, 408 U.S. 593 (1972); Board of Regents v. Roth, 408 U.S. 564 (1972); Ashe & DeWolfe, *supra* note 12, at 579–613.

21. Keyishian v. Board of Regents, 385 U.S. 589 (1967). In *Keyishian*, the teachers were not rehired due to their failure to sign an affidavit, which was required by statute, stating that they were not Communists. *Id.* at 592. The Supreme Court found that the New York statute which barred from employment in public schools any persons wilfully advocating or teaching the forcible overthrow of the government was unconstitutional. *Id.* at 604. Justice Brennan, writing for the majority, based his conclusion partly upon vagueness principles, but he carefully noted that teachers' employment could not be conditioned upon surrender of constitutional rights. *Id.* at 605; *see* cases cited in note 20 *supra*.

For a thorough review of the constitutional rights of teachers in light of their performance of a governmental function, *see* Van Alstyne, *The Constitutional Rights of Teachers and Professors*, 1970 DUKE L.J. 841; *Developments in the Law — Academic Freedom*, 81 HARV. L. REV. 1045, 1065–1128 (1968) [hereinafter cited as *Academic Freedom*].

22. For examples of situations in which teachers were allegedly dismissed for unconstitutional reasons, *see* McLaughlin v. Tilendis, 398 F.2d 287 (7th Cir. 1968) (teacher dismissed for exercising his right to join a union); Johnson v. Branch, 364 F.2d 177 (4th Cir. 1966), *cert. denied*, 385 U.S. 1003 (1967) (teacher dismissed for exercising her right to engage in civil rights activity). *See also* Griffis & Wilson,

granted to school boards by the right-privilege doctrine,[23] education officials, nevertheless, may qualify the first amendment freedoms of their employees in certain circumstances, since teachers still enjoy no constitutional right to work.[24]

Presented with the worrisome problem of defining the limits of teachers' first amendment freedoms, the Supreme Court responded in *Pickering v. Board of Education*[25] with a call for a balancing of interests.[26] In *Pickering,* generally regarded as the modern manifesto of first amendment rights of public school teachers,[27] Justice Marshall noted that the state's interests in governing its citizens differed in kind from its interests in regulating its own employees.[28] He sketched the proper parameters of teachers' rights in oft-cited dicta:

> The problem in any case is to arrive at a balance between the interests of the teacher, as a citizen . . . and the interest of the State, as an employer, in promoting the efficiency of the public services it performs through its employees.[29]

Constitutional Rights and Remedies in the Non-Renewal of a Public School Teacher's Employment Contract, 25 BAYLOR L. REV. 549 (1973); Jacobsen, Sperry & Jensen, *The Dismissal and Non-Reemployment of Teachers,* 1 J. LAW & EDUC. 435 (1972).

23. *See* note 20 *supra.* For a discussion of the major misconceptions regarding the discretion of school boards, *see* Note, *An Illinois Teacher's Right to Retention,* 48 CHI.-KENT L. REV. 80, 82–85 (1971).

24. Donahue v. Staunton, 471 F.2d 475 (7th Cir. 1972), *cert. denied,* 410 U.S. 955 (1973); Moore v. Winfield City Bd. of Educ., 452 F.2d 726 (5th Cir. 1971); Pred v. Board of Pub. Instruction, 415 F.2d 851 (5th Cir. 1969). *See also* Slochower v. Board of Educ., 350 U.S. 551 (1956). In *Slochower,* the Supreme Court described the "no constitutional right to work" concept as follows: "To state that a person does not have a constitutional right to government employment is only to say that he must comply with reasonable, lawful and nondiscriminatory terms laid down by the proper authorities." *Id.* at 555. Thus, the "no constitutional right to work" tenet of public employment has not been interpreted literally by the Supreme Court to allow public employers to impose unreasonable and unconstitutional terms.

25. 391 U.S. 563 (1968).

26. The courts have frequently resorted to balancing the divergent interests of private citizens and governmental authorities in the context of first amendment freedoms. *See, e.g.,* Konigsberg v. State Bar, 366 U.S. 516 (1960); Bates v. Little Rock, 361 U.S. 516 (1960); Barenblatt v. United States, 360 U.S. 109 (1959). In *Barenblatt,* the Court employed a balancing test to determine the superior interest between the congressional power of inquiry into alleged Communist infiltration into the education field and the individual's first amendment rights protecting him from compelled disclosure. *Id.* at 126–34.

It should be noted that the Court has unanimously held that one's constitutional right to use desegregated facilities cannot be balanced away. An attempt to do so in Aaron v. Cooper, 163 F. Supp. 13, 27 (E.D. Ark.) *rev'd,* 257 F.2d 33 (8th Cir. 1958) was rejected by the Supreme Court, which held that "law and order are not here to be preserved by depriving the Negro children of their constitutional rights." Aaron v. Cooper, 358 U.S. 1, 16 (1958).

27. Clark v. Holmes, 474 F.2d 928, 930 (7th Cir. 1972), *cert. denied,* 411 U.S. 972 (1973).

28. 391 U.S. at 568.

29. *Id.*

Justice Marshall deftly avoided articulating an absolute standard,[30] thereby requiring the lower courts to engage in a balancing analysis on a case-by-case basis.[31]

The significance of the *Cook* case lies in the novel interests pitted against one another before the Fifth Circuit, which was prepared with only the vague guidepost of *Pickering*. Despite a firm national commitment to the eradication of racial discrimination from all public schools,[32] the teachers in *Cook* sought to exercise their first amendment rights to associate freely[33] with groups who practiced racial discrimination.[34] Framed in the balancing language suggested by *Pickering*, the *Cook* case posed this question: Should the balancing between the parents' interest in freedom of association

30. *Id.* at 569.

Justice Marshall commented: "Because of the enormous variety of fact situations . . . we do not deem it either appropriate or feasible to attempt to lay down a general standard against which all such statements may be judged." *Id.*

31. Justice Marshall did, however, identify certain factors to be considered, the most important of which was the extent to which the protected activity interferes with proper performance of the employee's duty. *Id.* at 572–73. Other legitimate interests mentioned by the Court were: 1) the need to maintain discipline or harmony; 2) the need for confidentiality in the speech context; and 3) the need to encourage a close and personal relationship between the employee and his superior. *Id.* at 569–72.

It is important to note that the *Pickering* balancing test has been used both to determine the legitimacy of the challenged restrictions and to evaluate the validity of a teacher's dismissal based upon protected activity. *Compare* Russo v. Central School Dist. No. 1, 469 F.2d 623 (2d Cir. 1972), *cert. denied*, 411 U.S. 932 (1973), *with* Phillips v. Adult Prob. Dep't, 491 F.2d 951 (9th Cir. 1974). For other express applications of the *Pickering* dicta, *see* Acanfora v. Board of Educ., 491 F.2d 498 (4th Cir.), *cert. denied*, 419 U.S. 836 (1974); Birdwell v. Hazelwood School Dist., 491 F.2d 490 (8th Cir. 1974); Muller v. Conlisk, 429 F.2d 901 (7th Cir. 1970).

32. Green v. Connally, 330 F. Supp. 1150, 1163 (D.D.C.), *aff'd sub nom.* Coit v. Green, 404 U.S. 997 (1971). Evidence of this federal public policy is plentiful. *See, e.g.*, Green v. County School Bd., 391 U.S. 430 (1968); Board of Educ. v. United States, 389 U.S. 840 (1967); Singleton v. Jackson Municipal Separate School Dist., 419 F.2d 1211 (5th Cir. 1970); United States v. Jefferson County Bd. of Educ., 380 F.2d 385 (5th Cir.), *cert. denied*, 389 U.S. 840 (1967). All of these cases reveal a modern trend toward the expanded use of the courts' plenary power to eliminate discrimination from the schools, where the sharp struggle to secure equal rights for all people first began. *See generally* Brown v. Board of Educ., 349 U.S. 294 (1955).

33. The right of freedom of association was fully recognized as a separate and complete right, inherently necessary to the other first amendment rights, by Justice Harlan in NAACP v. Alabama, 357 U.S. 449, 460 (1958). This general right of association is protected no matter how unpopular the groups' purposes or characteristics may be. NAACP v. Button, 371 U.S. 415, 444–45 (1963). For a comprehensive review of the case law in this area, *see* Annot., 33 L. Ed. 2d 865 (1972).

There has been an abundance of literature addressed to this newly recognized right. *See* Douglas, *The Right of Association*, 63 COLUM. L. REV. 1361 (1963); Emerson, *Freedom of Association and Freedom of Expression*, 74 YALE L.J. 1 (1964); Rice, *The Constitutional Right of Association*, 16 HASTINGS L.J. 491 (1965); Note, *Freedom of Association: Constitutional Right or Judicial Technique*, 46 VA. L. REV. 730 (1960). Likewise, the liberty of parents to choose schools for their children is a first amendment construct of this freedom of association. *See* cases cited in note 54 *infra*.

34. The courts have commented upon the right of segregated schools to exist in both Green v. Connally, 330 F. Supp. 1150, 1166 (D.D.C. 1971) and Norwood v. Harrison, 413 U.S. 455, 462 (1973). The conclusion reached by most courts is that the state may not prohibit the maintenance of such schools.

for their children and the public interest in providing an effective and nondiscriminatory school system be resolved in favor of the latter? Unfortunately, the Fifth Circuit's holding provided no simple answer to this question.

Judge Coleman prefaced his own analysis with a statement that the court should have "dismissed the case for failure to raise a substantial constitutional question."[35] In support of this conclusion, he developed an analogy between the board regulation at issue and the proscription of partisan political activity of federal employees upheld in *Mitchell*[36] and its modern counterpart, *United Civil Service Commission v. National Association of Letter Carriers.*[37] While Judge Coleman recognized the applicability of the *Pickering* model,[38] he implied that both *Mitchell* and *Letter Carriers* obviated the need to actually balance the interests presented in the instant case, since all necessary balancing could be regarded as having been settled by the Supreme Court in *Letter Carriers.*[39] The crux of his

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35. 511 F.2d at 748. Federal courts have original subject matter jurisdiction over cases which arise under the Constitution, laws, or treaties of the United States and involve an amount in excess of $10,000. 28 U.S.C. § 1331(a) (1970). If the allegations in the plaintiff's complaint are solidly based upon federal constitutional rights, a jurisdictional basis exists unless the claim is deemed frivolous by the court. C. WRIGHT, HANDBOOK OF THE LAW OF FEDERAL COURTS § 18, at 62 (2d ed. 1970). The following passage explains the meaning ascribed to the phrase "no constitutional question" by Judge Coleman:

> [T]he doctrine thus declared is, that although, in considering a motion to dismiss, it be found that a question adequate abstractly considered to confer jurisdiction was raised, if it likewise appear that such question is wholly formal, is so absolutely devoid of merit as to be frivolous, or *has been so explicitly foreclosed by a decision or decisions of this court as to leave no room for real controversy,* the motion to dismiss will prevail.

Equitable Life Assur. Soc'y v. Brown, 187 U.S. 308, 311 (1902) (emphasis added), *citing* New Orleans Waterworks Co. v. Louisiana, 185 U.S. 336, 345 (1901).

36. 330 U.S. at 103; *see* note 17 *supra.*

37. 413 U.S. 548 (1973), *noted in The Supreme Court, 1972 Term,* 87 HARV. L. REV. 55, 141 (1973) *and* 1973 UTAH L. REV. 479. In a 6–3 decision, the *Letter Carriers* Court reaffirmed the *Mitchell* decision upholding the Hatch Act's restrictions on employees' political activity. Interestingly, this holding must have surprised many commentators who had uniformly believed that the present-day vitality of *Mitchell* was in doubt. *See* Bruff, *supra* note 13, at 154–58; *Another Look, supra* note 20, at 150–51. Indeed, in one review of the decision, *Letter Carriers* was called a "defeat for free expression." Dorsen, *The Courts of Some Resort,* 1 CIV. LIB. REV. 82, 93 (1974).

38. 511 F.2d at 748. Utilizing a quote from *Letter Carriers* which cited to *Pickering,* Judge Coleman noted that the rights of teachers are subject to greater restrictions than those of private citizens. *Id., quoting* United States Civil Service Comm'n v. National Ass'n of Letter Carriers, 413 U.S. 548, 564 (1973), *citing* Pickering v. Board of Educ., 391 U.S. 563, 568 (1968).

39. *Id.* This portion of Judge Coleman's opinion does not provide any description of the exact rationale upon which he relied. Another possible interpretation of his allusion to *Mitchell* and *Letter Carriers* is that he merely accepted the school board's determination that the restriction contained in the board's policy was necessary or reasonable. Judge Coleman may have been hinting that the courts should pay deference

reasoning appears to be that both the Hatch Act,[40] whose validity was upheld against a first amendment attack in *Mitchell* and *Letter Carriers,*[41] and the board policy in the instant case were designed to promote the same governmental aims: preservation of public confidence in the system and assurance of the dedication of government employees to the unbiased operation of all services.[42] Therefore, he seemed to view the board policy as presumptively valid, not needing a fresh determination.

In addition to making the foregoing analogy, Judge Coleman also considered the teachers' initial assertion that the board policy impinged upon their rights to select the educational atmosphere for their children,[43] but he chose to reformulate the issue.[44] In almost a paraphrase of earlier cases,[45] he declared that simply because teachers enjoy the freedom to send

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to a school board's judgment and refrain from substituting its own ideas, lest school boards be stripped of their proper power. He quoted the following from *Mitchell:*

> "Congress and the President are responsible for an efficient public service. If, in their judgment efficiency may be best obtained by prohibiting active participation by classified employees in politics as party officers or workers, we [the Supreme Court] see no constitutional objection."

511 F.2d at 748, *quoting* 330 U.S. at 99. Paralleling the *Mitchell* view, this approach would involve only a minimal review by the court rather than a full-scale balancing of interests. However, since *Letter Carriers* was an overt balancing case, it seems probable that the interpretation in the text accompanying this note is the proper one. In this regard, the following language from *Letter Carriers* should be noted:

> Although Congress is free to strike a different balance than it has, if it so chooses, we think the balance it has so far struck is sustainable by the obviously important interests sought to be served by the limitations on partisan political activities now contained in the Hatch Act.

413 U.S. at 564.

40. *See* note 17 *supra.*

41. *See* notes 17 & 34 *supra.*

42. 511 F.2d at 748–49. Among the considerations faced by the Court in *Letter Carriers* was a concern that the execution of federal laws by politically active employees might be biased and that any favortism exhibited by the employees might tend to deteriorate public confidence. 413 U.S. at 565. Presumably, the *Letter Carriers* Court found that preservation of a non-partisan work force, free from the pernicious influences of bias, sufficiently overbalanced the employees' first amendment freedoms. Judge Coleman found this rationale equally persuasive in *Cook,* stating:

> [D]oes the United States Constitution deny a public school board the authority to adopt and uniformly enforce a policy clearly designed . . . to insure the undivided dedication of its teachers (and the appearance of that dedication) to the public school function? . . . I respond that it does not.

511 F.2d at 749.

43. 511 F.2d at 749.

44. *Id.* at 749; *see* note 39 *supra.* It is interesting to note that Judge Coleman seemed unconvinced of the genuineness of the "parental" right as a full-fledged constitutional right: "The right of the teacher-appellants to send their children to private school, *whether grounded in the Constitution or not,* is not at stake in this appeal." *Id.* at 748 (emphasis added). Perhaps these words provide a hint to the lack of importance of this right in Judge Coleman's mind and to his willingness to override the parental interest in this opinion.

45. Judge Coleman's language is reminiscent of the privilege doctrine cases, most notably *Adler. See* note 18 *supra.*

their children to segregated schools does not mean that they have a constitutional right to continued public employment while engaging in this activity.[46]

In a separate opinion affirming the district court's decision, Judge Roney also declined to apply the *Pickering* balancing test but for a different reason. Viewing the board policy as a particular means of implementing court-ordered desegregation,[47] he specifically avoided analyzing the issue of the policy's constitutionality and voted to affirm the district court's dismissal "on the particular facts of this case on a very narrow ground."[48] Judge Roney reviewed the findings of the lower court to determine whether the school board acted arbitrarily or irrationally in failing to renew the contracts of these teachers.[49] Concluding that the school officials had acted within their discretionary authority,[50] he based his decision upon his belief that the teachers' dismissals were mandated by the prior command of the district court[51] to eliminate segregation.[52]

The affirming judges' evasion of the task of carefully identifying and weighing the competing interests of the school board and the teachers constituted a deviation[53] from the traditional balancing methodology established by *Pickering*. Contrary to the view expressed by Judge Coleman,

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46. 511 F.2d at 749. Judge Coleman said:

> [P]ersons employed or seeking employment in public schools have no right *to do so on their own terms* . . . . [T]o maintain the integrity of public schools as part of an ordered society school authorities have the *right* and the *duty* to screen teachers in a relevant manner. . . .

Id., citing Adler v. Board of Educ., 342 U.S. 485, 492 (1952) (emphasis supplied by the court).

47. 511 F.2d at 749–50.

48. *Id.* Judge Roney commented that "[t]his case, to me, does not have broad implications." *Id.* at 750.

49. *Id.*

50. *Id.*

51. *See* note 4 *supra.*

52. 511 F.2d at 750. Confining his concern to the particular decision of the board not to rehire the teachers, Judge Roney reiterated the district court's findings that the only purpose in not rehiring was "to strengthen local support for the public schools and to effectively implement the court-ordered requirement to change from a dual segregated school system to a unitary nondiscriminatory system." *Id.* Judge Roney did express, without elaboration certain reservations about the validity of the board's action "under less compelling circumstances." *Id.*

53. The Fifth Circuit has not been loath to engage in a balancing of state interests against private first amendment freedoms on prior occasions. *See* Battle v. Mulholland, 439 F.2d 321 (5th Cir. 1971) (black policeman alleging discharge due to his association with two white women; court balanced policeman's freedom of expression against state's interest in keeping police force from becoming a focus of racial tensions); Pred v. Board of Pub. Instruction, 415 F.2d 851 (5th Cir. 1969) (teacher's participation in a teachers' association balanced against school's interests); Burnside v. Byars, 363 F.2d 744 (5th Cir. 1966) (high school regulation prohibiting students from wearing certain freedom buttons declared unreasonable; court balanced students' freedom of speech against state's interest in keeping school system free from disruption).

neither *Mitchell* nor *Letter Carriers* should have been controlling in the instant case for several reasons. First, as between the diverse interests of the public employees in each situation, the parental right claimed by the teachers has traditionally received greater judicial protection than the right of public employees to engage in partisan political affairs.[54] Secondly, Judge Coleman underscored the importance of public confidence in the public school system to an extent unwarranted by previous case law or logic.[55] At the same time, he oversimplified the court's task by failing to consider the patent racial purpose[56] — "the elimination of racial discrimination and its 'pervasive influence' from the public schools"[57] — which defendants claimed to be served by their action.[58] Clearly, *Cook* posed a segregation-related question[59] which Judge Coleman did not address and Judge Roney discussed incompletely.[60]

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54. The Supreme Court initially recognized the parental right in Pierce v. Society of Sisters, 268 U.S. 510 (1925). Since that time, the Court has expressly endorsed the superiority of the parental right relative to certain other state interests. *See* Wisconsin v. Yoder, 406 U.S. 205 (1972) *noted in* 18 VILL. L. REV. 955 (1973). In *Yoder,* a case involving a challenge on behalf of the Amish people to a compulsory education statute, the Court stated:

> [E]ven this paramount responsibility [providing public schools] was, in *Pierce,* made to yield to the right of parents to provide an equivalent education in a privately operated system . . . . [T]he values of parental direction of the religious upbringing and education of their children in their early and formative years have a high place in our society.

406 U.S. at 213–14. For the Supreme Court's classification of the parental right as fundamental, *see* Griswold v. Connecticut, 381 U.S. 479, 495 (1965) (Goldberg, J., concurring).

On the other hand, the rights involved in *Letter Carriers* do not occupy such a high place in public or judicial opinion. In *Letter Carriers,* Justice White explained how the federal employee's right to engage in political activity has sustained the consistent disapproval of "Congress, the Executive and the country" since the time of Thomas Jefferson. 413 U.S. at 564. For Justice White's review of the history, *see id.* at 557–64.

55. 511 F.2d at 749. Even if it is conceded that both the Hatch Act and the board policy shared a similar aim, the asserted decrease in public support which may occur because of associational activities has carried no impact in Supreme Court decisions and has been rejected as a justification in one state court decision. *See* Buckley v. Meng, 35 Misc. 2d 467, 476, 230 N.Y.S.2d 924, 934 (Sup. Ct. 1962). It has been noted that, particularly in the school system context, the community reaction to teachers' associational activities is largely immaterial. *See Academic Freedom, supra* note 21, at 1066 (suggesting that permitting restriction of teachers' rights upon the basis of public opinion is open to drastic abuse).

56. 511 F.2d at 749.

57. *Id.* at 751 (Clark, J., dissenting), *quoting* Cook v. Hudson, 365 F. Supp. 855, 860 (N.D. Miss. 1973).

58. 511 F.2d at 751.

59. The Supreme Court has held a Mississippi textbook program unconstitutional where it significantly aided the continuation of a separate private school system. Norwood v. Harrison, 413 U.S. 455 (1973). Speaking of discrimination in private schools, the Court said: "[A]lthough the Constitution does not proscribe private bias, it places no value on discrimination as it does on the values inherent on the Free Exercise Clause." *Id.* at 469–70. This dictum suggests that the right to associate in a racially discriminatory manner may be easily outweighed by the state's interest in nondiscriminatory schools. *See also* Green v. Connally, 330 F. Supp. 1150 (D.D.C.), *aff'd sub nom.* Coit v. Green, 404 U.S. 997 (1971).

60. *See* notes 47 & 56 and accompanying text *supra.*

It is suggested that a balancing analysis by its very nature requires a precise assessment of the particular interests presented by the facts of each case, and that the device of analogy chosen by Judge Coleman did not enable the *Cook* court to identify these interests. Even the Supreme Court has recognized the futility of articulating a generally applicable standard for those cases within the purview of the first amendment.[61] *Letter Carriers,* a decision with real precedential value only in very close factual situations, reflected the Court's judgment of the constitutional relationship between two definite interests. Only by identifying and comparatively balancing the specific interests at stake in *Cook* could the Fifth Circuit have ensured that constitutional freedoms of the plaintiff-teachers were not unnecessarily diluted.[62]

In addition to the Fifth Circuit's undue reliance upon the *Mitchell* and *Letter Carriers* cases, the affirming judges' reasoning was inconsistent with several established trends in the case law. By repeating the *Adler* shibboleth that employees have no constitutional right to work,[63] Judge Coleman inherited nearly 20 years of adverse criticism.[64] While his apparent attempt to avoid undermining the authority of the school officials to set educational policy was not without some persuasive logic,[65] the courts, confronted with first amendment challenges against legislative and

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61. Pickering v. Board of Educ., 391 U.S. 563, 569 (1968); *see* note 30 *supra.* As the Second Circuit said in dictum about first amendment analysis:

> The best one can hope for is to discern lines of analysis and advance formulations sufficient to bridge past decisions with new facts. One must be satisfied with such present solutions and cannot expect a clear view of the terrain beyond the periphery of the immediate case.

Eisner v. Stamford Bd. of Educ., 440 F.2d 803, 804 n.1 (2d Cir. 1971). For more abstract discussions of the balancing test, *see generally* Dennis v. United States, 341 U.S. 494, 517 (1951) (Frankfurter, J., concurring); Frantz, *The First Amendment in the Balance,* 71 YALE L.J. 1424 (1962); Mendelson, *On the Meaning of the First Amendment; Absolutes in the Balance,* 50 CALIF. L. REV. 821 (1962).

62. Judge Coleman's opinion may have been misleading in that he couched his analysis in balancing language, but failed to actually identify and weigh the factors.

63. 342 U.S. at 492; *see* note 18 *supra.*

64. *See* notes 18, 20 & 22 and accompanying text *supra.*

65. One article took the following view toward the desirability of school board autonomy:

> Particularly where the teacher places himself in a position antagonistic to the school administration, the competing interests of the teacher as a private individual and the school administration as an employer become difficult to balance.
>
> The school administration must be afforded wide discretion and latitude in controlling the routine operations and daily affairs of the school in order to meet the innumerable local problems which may occur. A school administration therefore has inherent powers to formulate rules and regulations consistent with its education interests.

administrative judgments,[66] have increasingly shown less deference to the overall capabilities of these expert officials.[67]

In contrast to the reasoning in Judges Coleman's and Roney's opinions, Judge Clark, in his dissenting opinion,[68] respected the *Pickering* Court's mandate by comprehensively identifying and reconciling the interests at stake in *Cook*. His two-part dissent analyzed the action taken by the board in both its rulemaking[69] and adjudicative capacities.[70] Differing with the district court's view,[71] Judge Clark indicated that the parental right, as a fundamental right, can be lawfully restricted only if the state can make a showing of a compelling state interest.[72] He found the requisite interest

66. *Another Look, supra* note 20, at 149–51.

When the exercise of a first amendment right impairs a teacher's effectiveness or conflicts with the performance of his or her job, the school board may lawfully refuse to rehire. An extension of constitutional protection merely to prevent an unfit teacher from being discharged would be unwarranted. Ferguson v. Thomas, 430 F.2d 852 (5th Cir. 1970). For one commentator's warning against transforming government employment into "a constitutionalized sinecure in the name of the first amendment," *see* Note, *The First Amendment & Public Employees — An Emerging Constitutional Right To Be A Policeman?*, 37 GEO. WASH. L. REV. 409, 424 (1968). The key determination to be made in the classroom context is how much interference with a teacher's daily duties or with the operation of the school will be tolerated by education officials before a constitutional guarantee can be justifiably curtailed. *See* notes 82–87 and accompanying text *infra*. Griffis & Wilson, *supra* note 22, at 550 (footnotes omitted). *See also* Smith v. St. Tammany Parish School Bd., 316 F. Supp. 1174, 1176 (E.D. La. 1970), *aff'd*, 448 F.2d 414 (5th Cir. 1971).

67. As the Second Circuit said in James v. Board of Educ., 461 F.2d 566 (2d Cir.), *cert. denied*, 409 U.S. 1042 (1972):

> The federal courts . . . cannot allow unfettered discretion to violate fundamental constitutional rights.
>
> The dangers of unrestrained discretion are readily apparent. Under the guise of beneficient concern for the welfare of school children, school authorities, albeit unwittingly, might permit prejudices of the community to prevail.

Id. at 575 (footnotes omitted).

68. 511 F.2d at 750 (Clark, J., dissenting).

69. *Id.* at 751–53.

70. *Id.* at 753. After dealing with the constitutionality of the policy, Judge Clark explained that the court should also scrutinize the underlying reasons for the dismissal to determine whether the teachers had been dismissed for constitutionally valid reasons. *Id.*

71. 365 F. Supp. at 860; *see* note 8 *supra*.

72. 511 F.2d at 751–52. While Judge Clark refrained from so labeling his test, he patched together equal protection principles to measure the acceptability of the limitations which the board policy imposed upon the fundamental right of the teacher-parents to direct the education of their children. *Id.* at 750–53.

In his opinion, the validity of the board's policy could be sustained only if the board proved the following elements: 1) a relation between the restriction and the public purpose; 2) the compelling nature of the public purpose; 3) the necessity of the restriction to achieve that purpose; and 4) a drafting of the restriction in the narrowest manner possible. *Id.* at 751–53. In Judge Clark's view, the first element was not sufficiently demonstrated since the only showing of a relationship between the board's policy and the elimination of discrimination was the testimony of the psychologists. *See* note 79 *infra*. The third element was not adequately shown since other less intrusive policies could easily have been adopted by the school board. For example, the board could have made separate evaluations of the teachers to determine those that did not provide positive reinforcement to the black students. *Id.* at 752–53. Finally, the board's policy was overbroad. *Id.* at 753. Since the policy failed to evidence the necessary elements, Judge Clark ultimately found it unconstitutional. *Id.*

in the state's duty to eliminate discriminatory influences from the school system.[73] However, he demonstrated that the policy failed to *narrowly* fit the state interest,[74] concluding that the regulation should not be upheld.[75]

Proceeding to an examination of the underlying causes for the dismissal of each teacher,[76] Judge Clark conceded that the same school board's interest in fostering a nondiscriminatory school system outweighed the teachers' interests under the *Pickering* balancing test.[77] Nevertheless, he observed that no balancing of these interests is required unless the interests are shown to conflict unavoidably.[78] Since the testimony of the psychologists provided no more than a speculative inference of possible conflict,[79] Judge Clark hinged his dissent upon the lack of a substantial nexus between the protected activity and the efforts to eliminate racial discrimination.[80] He adopted the "substantial and material interference" standard as the requisite threshold qualification.[81] Under this test, once an employee proves that his or her employment has been terminated due to an exercise of rights protected by the first amendment, such termination will be upheld[82] only if the state can show that the employee's exercise of that protected

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73. *Id.* at 751–52.

74. *Id.* at 752–53.

75. *Id.* It should be noted that traditional equal protection analysis is not the standard of scrutiny usually applied in evaluating alleged infringements of rights such as first amendment freedoms of expression and association, although these rights are equally susceptible to such an analysis. Equal protection treatment has more commonly been reserved for cases dealing with the following fundamental rights: the right to vote, the right to procreate, and rights related to criminal procedure. *See, e.g.*, Harper v. Virginia Bd. of Electors, 383 U.S. 663 (1966) (voting); Griffin v. Illinois, 351 U.S. 12 (1956) (criminal appeals); Skinner v. Oklahoma, 316 U.S. 535, 541 (1942) (procreation). As Justice Harlan has said, it is unnecessary to use the stringent equal protection test when the right affected is one assured by the Constitution or at least claiming clear support in constitutional history. *See* Shapiro v. Thompson, 394 U.S. 618, 659 (1969) (Harlan, J., dissenting). *See generally Equal Protection, supra* note 8, at 1127–30.

76. 511 F.2d at 753–57. This second step was a vital part of Judge Clark's analysis. Notwithstanding the board policy, the teachers' dismissals might still have been sustainable if an adjudicative inquiry revealed that each of the plaintiff-teachers had performed the duties inadequately.

77. 511 F.2d at 754–55. Judge Clark set forth the following test by which the school board must evaluate a particular teacher: "To sustain a determination of unfitness on the basis of protected activity, the governmental interest to be served must outweigh the infringement of personal liberty, *viewed in the special environment of the schoolroom.*" *Id.* at 753–54 (emphasis added).

78. *Id.* at 755.

79. *Id.* at 756. Clark placed little weight upon the opinions of the psychologists, evidencing a reluctance to abdicate to the psychologist or the psychiatrist the function and duties of the court. *Id.*

80. 511 F.2d at 757.

81. *Id.* at 756. Judge Clark prefaced his review of the cases with this summary:

> While no prior similar cases have dealt with precisely the kind of subtle psychological effect asserted here, they have uniformly required a showing of more than a speculative inference that constitutionally protected activity could interfere with a state interest.

Id.

82. Smith v. United States, 502 F.2d 512, 517 (5th Cir. 1974), *citing* Battle v. Mulholland, 439 F.2d 321 (5th Cir. 1971).

activity interfered with the "discharge of duties and responsibilities inherent in such employment."[83] It is contended that this standard most effectively safeguards both the rights of public school teachers and the integrity of the school system. To require the state to show only a reasonable relation between teacher conduct and the state's interest unfairly dilutes the teachers' constitutional protection which they have enjoyed since the erosion of the right-privilege doctrine. At the other extreme, to require the state to show a compelling state interest before restricting teachers' rights overly restricts the board's ability to regulate its employees effectively. Teachers are subject to greater state-imposed restrictions than ordinary citizens: due consideration must be given to the effects which the exercise of their rights has upon others — particularly school children. Judge Clark properly recognized the "substantial and material interference standard" to be an important middle-level solution. When a teacher's activity materially interferes with classroom duties, the first amendment balance should be tipped in favor of restricting the teacher's protected activity.

This interference criterion, articulated in several cases by both the Fifth Circuit[84] and the Supreme Court[85] as the balancing becomes "case hardened,"[86] is the closest the courts have come to articulating a per se rule in this fluid area and it has injected some desirable certainty into this difficult process of conflict resolution. Furthermore, the demonstration of a definite interference relationship should be a prerequisite to the curtailment of constitutional rights in this case since the greater restrictions of teachers' rights can be justified only *because* of their positions in the school

83. 511 F.2d at 756.

84. *See* Smith v. United States, 502 F.2d 512 (5th Cir. 1974) (federal employee's wearing of a peace pin while on duty at a veterans hospital found to result in a material and substantial interference with his duties as a psychologist); Battle v. Mulholland, 439 F.2d 321 (5th Cir. 1971) (substantial and material interference standard posited as the test to measure plaintiff's usefulness as a policeman); Burnside v. Byars, 363 F.2d 744 (5th Cir. 1966) (students' rights of freedom of expression could not be abridged where the exercise of such rights did not materially and substantially interfere with the requirement of appropriate discipline within the school); note 53 *supra*. *But cf.* Ferguson v. Thomas, 430 F.2d 852 (5th Cir. 1970); Doherty v. Wilson, 356 F. Supp. 35 (M.D. Ga. 1973) ("serious impairment of effectiveness as an instructor" stated as appropriate measure rather than "substantial and material interference").

85. *See* Tinker v. Des Moines Indep. Consol. School Dist., 393 U.S. 503 (1969). In this controversial decision, Justice Fortas held that absent a showing of possible substantial disruption or material interference with school activities, a school board's regulation prohibiting students from wearing black armbands was unconstitutional. *See also* Healy v. James, 408 U.S. 169 (1972); Grayned v. City of Rockford, 408 U.S. 104 (1972).

86. It is common in constitutional adjudication for the Court to begin with an ad hoc method of decisionmaking and, as more cases are decided, to move progressively toward a decisional method based upon the application of rules. When the transition is complete, the Court singles out a small number of critical factors and formulates them into a rule. The balancing test constructed by the Court in *Pickering* is illustrative of the ad hoc method. *See* Note, *Civil Disabilities and the First Amendment*, 78 YALE L.J. 842, 843–44 (1969).

system.[87] It is unfortunate, indeed, that the Fifth Circuit, one of the first courts to utilize the interference test,[88] ignored the opportunity presented in *Cook* to apply it.

Thus, it is suggested that Judge Clark's resolution of the case accorded concrete meaning to the seminal but incomplete *Pickering* formula. However, the Fifth Circuit's decision in *Cook* largely defeats the intention of the Supreme Court as delineated in *Pickering* despite Justice Marshall's caution against lightly overriding the newly restored freedoms of one class of public servants.[89]

Since the court did not require a demonstration that the teachers' exercise of their first amendment rights substantially interfered with the interests of the school board, the *Cook* holding conflicts with recent trends toward expanding first amendment protection within the school system[90] and toward checking the broad discretion of school authorities.[91] This expansion of protection has resulted from the use of the balancing test. The balancing process necessarily requires a functional approach to the considerations involved in any particular set of facts, an approach which guarantees vitality and accuracy in the application of the test. The *Cook* court, however, adopted a definitional approach, requiring only the categorization of the state's interests as employee loyalty and preservation of public confidence to settle the question. Through this approach, the judges omitted the very factors which distinguish *Cook* from other cases.

In conclusion, the *Cook* court should not have countenanced this setback in teachers' civil liberties without a showing that the protected conduct substantially and materially interfered with the performance of their services. It is hoped that the Supreme Court's decision in *Cook* later this term[92] will not similarly encourage other courts to seek shortcuts in the application of the critical balancing test; for without careful identification and evaluation of the opposing interests involved, the value of the test will be diminished.

Linda Lipscomb

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87. For examples of the importance of the relationship between the protected activity and the state's interests, *see* Acanfora v. Board of Educ., 491 F.2d 498 (4th Cir.), *cert. denied,* 419 U.S. 836 (1974); Cole v. Choctaw, 471 F.2d 777 (5th Cir.), *cert. denied,* 411 U.S. 948 (1973).

The school room has always been viewed as a sensitive area, especially in light of the strong policy of ensuring that the nation's youth receive a proper education from qualified teachers. *See generally* Beilan v. Board of Educ., 357 U.S. 399 (1958).

88. *See* note 84 *supra.*

89. 391 U.S. at 568.

90. *See* notes 21 & 22 and accompanying text *supra.*

91. *See* notes 66 & 67 and accompanying text *supra.*

92. The Supreme Court has granted certiorari in *Cook.* 44 U.S.L.W. 4246 (U.S. March 2, 1976) (No. 75-503).

CORPORATIONS — FIDUCIARY DUTY — SHAREHOLDERS IN A CLOSE CORPORATION OWE TO ONE ANOTHER SUBSTANTIALLY THE SAME FIDUCIARY DUTY OWED BY PARTNERS TO ONE ANOTHER.

Donahue v. Rodd Electrotype Co. of New England
(Mass. 1975)

Plaintiff, Euphemia Donahue, was a minority shareholder in Rodd Electrotype Company of New England, Inc. (the corporation), a closely held Massachusetts corporation.[1] The majority shareholders, members of the Rodd family (the Rodds),[2] held most of the managerial and directorial positions in the corporation.[3] The corporation, as authorized by the board of directors, purchased a portion of the shareholdings from one of the Rodds,[4] and after learning of the purchase, plaintiff offered her shares to the corporation on the same terms. Upon rejection of her offer, Mrs. Donahue brought suit[5] against the corporation, Charles Rodd, Frederick Rodd, and Harold Magnuson as directors, and Harry Rodd as a former director, officer, and controlling shareholder, to rescind the corporation's purchase.[6] The complaint alleged that the Rodds, by their failure to accord her an equal opportunity to sell a ratable number of her shares, had violated the fiduciary duty they owed to her as a minority shareholder.[7] The trial court dismissed the action, holding that the purchase did not prejudice the plaintiff, and impliedly finding that the transaction had been made in good faith.[8] In affirming the findings of the trial court, the Appeals Court held that neither the corporation nor its directors

1. Donahue v. Rodd Electrotype Co. of New England, ___ Mass. ___, 328 N.E.2d 505 (1975). Plaintiff and her husband had been joint owners of 50 shares. They subsequently transferred five shares to their son. Upon her husband's death, plaintiff became the sole owner of the 45-share block. *Id.* at ___ n.8, 328 N.E.2d at 510 n.8.

2. Prior to complete divestiture of his holdings, Harry Rodd held 81 shares, his sons, Charles and Frederick, each held 39 shares, and his daughter, Phyllis Mason, held 39 shares. *Id.* at ___, 328 N.E.2d at 510.

3. Upon his father's resignation as a director of the corporation, Frederick Rodd joined his brother, Charles, and Harold Magnuson, clerk of the corporation, as a director of the corporation. *Id.* Prior to his retirement, Harry Rodd served as president of the corporation, and his son Charles served as vice-president. Charles later succeeded his father as president. *Id.* at ___, 328 N.E.2d at 509–10.

4. The corporation purchased 45 shares at $800.00 per share from Harry Rodd, leaving his total holdings in the corporation at 36 shares. Harry then distributed these remaining shares equally among his three children. The resulting share distribution in the corporation was as follows: Charles Rodd, Frederick Rodd, and Phyllis Mason each held 51 shares; Mrs. Donahue held 45 shares; Robert Donahue, plaintiff's son, held five shares. *Id.* at ___, 328 N.E.2d at 510.

5. Though in form the suit partially presented a derivative action brought on behalf of the corporation, the court noted that the plaintiff was actually alleging the breach of a personal right, a fiduciary duty owed to her, and decided the instant case on that basis. *Id.* at ___ n.4, 328 N.E.2d at 508 n.4; *see* note 62 *infra*.

6. *Id.* at ___, 328 N.E.2d at 508.

7. *Id.*

8. *Id.*

were obligated to buy shares ratably from all shareholders.[9] On review, the Supreme Judicial Court of Massachusetts reversed,[10] holding that shareholders in a close corporation owe each other essentially the same fiduciary duty in the conduct of corporate affairs that partners owe to each other, and remanded to the Superior Court, with directions to award one of two alternative forms of relief: 1) rescission of the purchase transaction, or 2) purchase by the corporation of all the plaintiff's shareholdings in Rodd Electrotype. *Donahue v. Rodd Electrotype Co. of New England,* ____ Mass. ____ 328 N.E.2d 505 (1975).

A fiduciary relationship has been said to arise when "one holds a position of superiority and influence over the interests of another such that the latter is forced to rely upon the good faith and fair dealing of the former . . . ."[11] In all jurisdictions,[12] corporate directors and officers are said to occupy a fiduciary position.[13] Moreover, partners are held to owe each other the highest degree of good faith in the exercise of all partnership operations.[14] However, it is generally held that a shareholder is under no fiduciary duty to either the corporation or to other shareholders by virtue of the mere ownership of stock.[15]

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9. Donahue v. Rodd Electrotype Co. of New England, 307 N.E.2d 8 (Mass. App. Ct. 1974).

10. The court restricted the applicability of its holding to those corporations falling within the ambit of its definition of the close corporation, ____ Mass. at ____, 328 N.E.2d at 511. For a discussion of the court's definition of a close corporation, *see* text accompanying note 37 *infra.*

11. 3 H. OLECK, MODERN CORPORATION LAW § 1569, at 624 (1959) (footnote omitted) [hereinafter cited as OLECK].

12. *See* 3 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 838 (perm. ed. rev. 1965) [hereinafter cited as FLETCHER].

13. The fiduciary obligation of a director was described by one Massachusetts court as requiring those who occupy such positions to

> act with absolute fidelity and . . . place their duties to the corporation above every other financial or business obligation. They must act, also, with reasonable intelligence, although they cannot be held responsible for mere errors of judgment or want of prudence. They cannot be permitted to serve two masters whose interests are antagonistic. They are liable if, through their bad faith, financial loss to the corporation results. They are responsible if they unlawfully divert the assets of the corporation.

Spiegel v. Beacon Participations, Inc., 297 Mass. 398, 410–11, 8 N.E.2d 895, 904 (1937). For a thorough examination of the fiduciary obligations of corporate directors in Massachusetts, *see* Tilden, *The Fiduciary Duty of Corporation Directors in Massachusetts,* 28 B.U.L. REV. 265 (1948).

In the pioneer case of Smith v. Hurd, 12 Mass. 371, 46 Am. Dec. 690 (1847), the Supreme Judicial Court of Massachusetts found that this fiduciary duty was owed only to the corporation, and not to the individual shareholders. *Id.* at 384, 46 Am. Dec. at 691.

14. *See, e.g.,* Cardullo v. Landau, 329 Mass. 5, 105 N.E.2d 843 (1952); Shelley v. Smith, 271 Mass. 106, 170 N.E. 826 (1930).

15. 13 FLETCHER, *supra* note 12, § 5811, at 108; *see* Jackson v. Hooper, 76 N.J. Eq. 592, 75 A. 568 (1910), as an early example of the view that partners who subsequently adopt the corporate form are no longer burdened with a partnership fiduciary duty, but "have only the rights, duties and obligations of stockholders. They cannot be partners *inter sese* and a corporation to the rest of the world." *Id.* at 599, 75 A. at 571.

Some courts have held that a controlling shareholder who chooses to determine corporate policy, thereby possibly jeopardizing the interest of the noncontrolling shareholders, is under a fiduciary duty to those shareholders,[16] but it is not clear that Massachusetts has adopted this exception to the general rule.[17] In the early case of *Von Arnin v. American Tubeworks,*[18] a minority shareholder of a close corporation brought an action against the corporate officers for misappropriation of corporate funds. In affirming a decree overruling a demurrer to the shareholder's complaint,[19] the Supreme Judicial Court of Massachusetts did not acknowledge the existence of any particular duty owed by the controlling shareholder-officers to the noncontrolling shareholder, other than that generally owed by them as a result of their managerial capacity.[20] Several years later, in *Leventhal v. Atlantic Finance Corp.*,[21] the court made express the implication of *Von Arnin,* and held that, as the relationship between corporate shareholders was not ordinarily that of partners, a shareholder of a two-man corporation did not stand in any fiduciary relationship with the other shareholder.[22]

However, the Supreme Judicial Court of Massachusetts has imposed fiduciary relationships upon shareholders in some cases, apparently depending upon the existence of an extracorporate relationship between the parties. In *Mendelsohn v. Leather Manufacturing Co.*[23] and *Silversmith*

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16. OLECK, *supra* note 11, § 1569, at 625. The nature of this duty was aptly described by the United States Supreme Court in Pepper v. Litton, 308 U.S. 295 (1939):

> A director is a fiduciary. . . . So is a dominant or controlling stockholder or group of stockholders. . . . Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein.

Id. at 306 (citations omitted). *See also* Note, *The Fiduciary Duty of Controlling Shareholders,* 7 W. RES. L. REV. 467 (1956).

17. Other jurisdictions have generally held that this fiduciary duty is owed by controlling shareholders directly to the noncontrolling shareholders. *See, e.g.,* Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947) (construing Kentucky law); Jones v. H.F. Ahmanson & Co., 1 Cal. App. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); Kirtz v. Grossman, 463 S.W.2d 541 (St. Louis Ct. of App. 1971).

18. 188 Mass. 515, 74 N.E. 680 (1905).

19. *Id.* at 521, 74 N.E. at 682.

20. *Id.* at 519, 74 N.E. at 681.

21. 316 Mass. 194, 55 N.E.2d 20 (1944).

22. *Id.* at 198–99, 55 N.E.2d at 23. In arriving at this conclusion, the court examined a contract entered into by the two corporate shareholders to which the corporation was also a party. The contract provided guidelines for the operation of the corporation, transfer of stock, and liquidation. *Id.* at 197–98, 55 N.E.2d at 22. The court determined that the contract between the shareholders and the corporation did not create a partnership-like relationship between the parties. *Id.* at 199, 55 N.E.2d at 24.

23. 326 Mass. 226, 93 N.E.2d 537 (1950). *Mendelsohn* involved a sale by one shareholder to another shareholder of all the former's corporate stock. The court held that the sale was untainted by fraud or misrepresentation. *Id.* at 235–37, 93 N.E.2d at 542–43.

v. Sydeman,[24] Massachusetts' highest court found a fiduciary relationship[25] to exist between shareholders who had acted as joint venturers prior to incorporation, or were acting as joint venturers after incorporation.[26] In *Sher v. Sandler*,[27] the court determined that a fiduciary relationship, which required full disclosure of information concerning corporate transactions, existed between the two shareholders[28] who had entered into a pre-incorporation agreement requiring such disclosure.[29] A few years later, in *Samia v. Central Oil Co. of Worcester*,[30] the court recognized that the familial relationship between the shareholders,[31] as well as the administration of a family estate by one shareholder-brother, gave rise to a fiduciary relationship between the shareholders.[32]

In its most recent decision prior to *Donahue, Wilson v. Jennings*,[33] the Supreme Judicial Court of Massachusetts concluded that the relationship between the three corporate shareholders was one of trust and confidence.[34] The court justified the imposition of this fiduciary relationship on the basis of the shareholders' arrangement for a three-way permanent, equal division of the corporate stock, the shareholders' "mutual understanding" that full disclosure would be made, and the joint venture structure employed by the shareholders to market their invention.[35]

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24. 305 Mass. 65, 25 N.E.2d 215 (1940). In *Silversmith*, the court held that a shareholder-officer of a two-man corporation had wrongfully withheld interest payments on money loaned by him to the corporation. *Id.* at 70, 25 N.E.2d at 218.

25. 326 Mass. at 233, 93 N.E.2d at 541; 305 Mass. at 68, 25 N.E.2d at 217. While the nature of this fiduciary duty was not expressly described by the court in *Silversmith*, the duty was described in *Mendelsohn* as one which required full disclosure between shareholders of all corporate matters. 326 Mass. at 233, 93 N.E.2d at 541.

26. 326 Mass. at 233, 93 N.E.2d at 541; 305 Mass. at 68, 25 N.E.2d at 217. The term "joint venture" is generally used to describe a business relationship comparable to that of a partnership which is formed by two or more persons to carry out a particular undertaking of limited scope, in which each participant usually has a pecuniary interest. Jaeger, *Joint Adventures: Origin, Nature and Development*, 9 AM. U.L. REV. 1, 5–14 (1960). *See generally* Mechem, *The Law of Joint Adventures*, 15 MINN. L. REV. 644 (1931).

27. 325 Mass. 348, 90 N.E.2d 536 (1950).

28. *Id.* at 353, 90 N.E.2d at 539. This relationship was characterized as

> a duty of disclosure similar to that owed by a fiduciary in his dealings with his beneficiary. In such dealings the fiduciary owes the beneficiary the duty to make the fullest disclosure and unless he does so the transaction can be set aside.

Id.

29. *Id.*

30. 339 Mass. 101, 158 N.E.2d 469 (1959).

31. *Id.* at 105, 158 N.E.2d at 472. Suit was brought by three sisters as minority shareholders, against their brothers, the majority shareholders in a close family corporation. The minority shareholders alleged a breach of trust by the majority shareholders because of the failure of the majority shareholders to issue to a deceased brother 20 shares of stock to which he had subscribed prior to his death and to which the sisters had become entitled upon his death. *Id.* at 106, 112–13, 158 N.E.2d at 472, 476–77.

32. *Id.* at 112–13, 158 N.E.2d at 476–77. The court stated that as fiduciaries, the brothers were required to "keep and render accounts" and show proper disposition of funds received by them. *Id.* at 126, 158 N.E.2d at 484–85.

33. 344 Mass. 608, 184 N.E.2d 642 (1962).

34. *Id.* at 615, 184 N.E.2d at 646.

35. *Id.* at 614–15, 184 N.E.2d at 646.

It was against this historical framework that *Donahue* departed from a case-by-case determination of shareholder fiduciary duties by defining a duty applicable to all shareholders in close corporations, regardless of the existence of other external factors. Crucial to the court's analysis was its distinction between the close corporation and the publicly held corporation,[36] which gave rise to the court's adoption of a definition describing the close corporation as one which has "(1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in the management, direction and operations of the corporation."[37] The court stressed the similarities between the close corporation and a partnership, placing particular emphasis upon the integration of ownership and management, restrictions on share transfers to others than the original owners, and the dependence of co-owners upon one another to ensure the success of the venture.[38]

The *Donahue* court focused on the disadvantage of the corporate form to the minority shareholder which occurs in the form of "freeze-outs,"[39] and reasoned that, unlike his counterpart in the publicly held corporation, the minority shareholder in the close corporation has no remedy against oppressive majority tactics.[40] Thus, to afford greater protection to the minority shareholder in the close corporation, and because of the significant resemblance of that corporate form to a partnership,[41] the court imposed the stringent fiduciary duty owed by partners to each other[42] upon con-

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36. ____ Mass. at ____, 328 N.E.2d at 514.

37. *Id.* at ____, 328 N.E.2d at 511.

38. *Id.* at ____, 328 N.E.2d at 512. For a discussion of the similarities between close corporations and partnerships, *see* Hancock, *Minority Interests in Small Business Entities*, 17 CLEV.-MAR. L. REV. 130 (1968); Israels, *The Close Corporation and the Law*, 33 CORNELL L.Q. 488 (1948).

39. ____ Mass. at ____, 328 N.E.2d at 513. A freeze-out has been described as a manipulative use of corporate control or inside information to eliminate minority shareholders from the enterprise, or to reduce to relative insignificance their voting power or claims on corporate earnings and assets or otherwise to deprive them of corporate income or advantages to which they are entitled.
2 F. O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE § 8.07, at 43 (1971) [hereinafter cited as O'NEAL].

Freeze-outs can occur in various ways: 1) issuance of new shares subsequently bought by majority shareholders at an inadequate price; 2) merger of the corporation to the detriment of the minority; 3) exorbitant compensation to officers; 4) refusal to declare dividends. *Id.; see* Note, *Freezing Out Minority Shareholders*, 74 HARV. L. REV. 1630 (1961).

40. ____ Mass. at ____, 328 N.E.2d at 514–15. The court noted that the unavailability of a market, coalesced with the difficulty of achieving dissolution as provided by MASS. GEN. LAWS ANN. ch. 156B, §§ 99(a), (b), 100(a)(2) (1970), to leave the minority shareholder in the close corporation with an illiquid investment, often compelling him to sell his shares to the controlling shareholders at unreasonably low prices. ____ Mass. at ____, 328 N.E.2d at 515.

41. *See* note 38 and accompanying text *supra*.

42. ____ Mass. at ____, 328 N.E.2d at 515. *See* note 14 and accompanying text *supra*. This fiduciary duty was described by one commentator as a "stringent standard" which arises from the fundamental nature of a partnership. In a partnership each partner is the confidential agent of his copartners and vice versa. Therefore, every partner

trolling shareholders in a close corporation.[43] To justify its imposition of such a strict fiduciary obligation within a corporate form, the *Donahue* court looked to past cases in which a fiduciary relationship was found due to certain extracorporate factors.[44]

The court concluded that this strict fiduciary duty required that a close corporation which has repurchased shares from a controlling shareholder must offer to each other shareholder an opportunity to sell a ratable number of his shares at an identical price,[45] in order that the controlling shareholder not create "an exclusive market in previously unmarketable shares from which the minority shareholders are excluded."[46] Thus, the failure of the Rodds, as controlling shareholders,[47] to cause the corporation to offer to Mrs. Donahue an opportunity to sell a ratable number of her shares on the same terms as those given to Harry Rodd[48] constituted a breach of the stringent fiduciary duty owed to her as a noncontrolling shareholder.[49]

While the *Donahue* court relied upon prior cases imposing fiduciary duties upon shareholders as support for its instant decision, it is submitted that this reliance was not justified since these cases can all be distinguished on their facts. *Donahue* does not fall within the reach of cases such as

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has a right to information the others possess, and no one may act at the expense of his copartners. Furthermore, a secret profit may not be made to the exclusion of copartners.

Note, *Fiduciary Duties of Partners*, 48 IOWA L. REV. 902, 907–08 (1963) (footnotes omitted). The *Donahue* court noted that this fiduciary duty involves "[n]ot honesty alone, but the punctilio of an honor the most sensitive.'" ____ Mass. at ____, 328 N.E.2d at 516, *quoting* Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928).

43. ____ Mass. at ____, 328 N.E.2d at 515. The holding was not limited in application to majority shareholders in a close corporation, but rather applied to the controlling shareholders in a close corporation, whether majority or minority shareholders. *Id.* at ____ n.17, 328 N.E.2d at 515 n.17.

44. The court relied upon Silversmith v. Sydeman (*see* notes 24–26 and accompanying text *supra*); Mendelsohn v. Leather Mfg. Co. (*see* notes 23 & 25–26 and accompanying text *supra*); Sher v. Sandler (*see* notes 27–29 and accompanying text *supra*); Samia v. Central Oil Co. (*see* notes 30–32 and accompanying text *supra*); and Wilson v. Jennings (*see* notes 33–35 and accompanying text *supra*).

45. ____ Mass. at ____, 328 N.E.2d at 518. The court observed that the offer of an equal opportunity to sell a ratable number of shares would not be required in all situations, such as when all shareholders had given advance consent to the purchase in the articles of organization, bylaws, or in a shareholders' agreement, or the purchase had been ratified by all shareholders. *Id.* at ____ n.24, 328 N.E.2d at 518 n.24.

46. *Id.* at ____, 328 N.E.2d at 518. It is arguable that, by requiring a corporation to offer to purchase a ratable number of shares from all shareholders, the court's holding may make it impossible for a corporation to repurchase shares from a controlling shareholder since the corporation could possibly be confronted with purchase demands which, if complied with, would lead to insolvency.

47. The court determined that "[t]he Rodds have retained the paramount management positions. Through their control of these management positions and of the majority of the Rodd Electrotype stock, the Rodds effectively controlled the corporation." *Id.* at ____, 328 N.E.2d at 519.

48. *See* note 4 *supra*.

49. ____ Mass. at ____, 328 N.E.2d at 520.

Mendelsohn, as the shareholders in *Donahue* did not act as joint venturers prior to their incorporation. Further, *Donahue* cannot look to the existence of a familial relationship among all shareholders, such as that present in *Samia,* to justify the imposition of a fiduciary duty, for the shareholders of Rodd Electrotype were not all members of the same family. Moreover, no preincorporation agreement expressly requiring full disclosure was entered into by the Rodds and Mrs. Donahue, which could have given rise to a fiduciary relationship similar to that found in *Sher,* and no permanent equal division of stock was agreed upon in the instant case as in *Wilson,* which contributed, in that case, to the imposition of the fiduciary relationship.

The *Donahue* court's reliance upon these cases as support for its instant decision manifests its desire to isolate the close corporation as a unique corporate entity and to define the scope of the application of the strict fiduciary duty. However, it is submitted that the adequacy of the court's definition of the close corporation[50] can be questioned. Generally,

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50. The fact that the *Donahue* court attempted to define the close corporation is, in itself, noteworthy, since this task has been all but ignored by the courts, who seem to have placed the burden on the legislatures.

In 1963, Florida enacted the first and, to date, the only *separate* close corporation statute. FLA. STAT. ANN. §§ 608.70–.77 (Supp. 1975). The Florida statute defines the close corporation as "a corporation for profit whose shares of stock are not generally traded in the markets maintained by securities dealers or brokers." *Id.* § 608.70(2).

In 1967, Delaware enacted a separate subchapter to its general corporation law which deals exclusively with close corporations. DEL. CODE ANN. tit. 8, §§ 341–56 (1975). Delaware defines the close corporation as one whose certificate of incorporation provides:

> (1) All of the corporation's issued stock of all classes . . . shall be held of record by not more than a specified number of persons, not exceeding 30; (2) All of the issued stock of all classes shall be subject to 1 or more of the restrictions on transfer permitted by § 202 of this title; and (3) The corporation shall make no public offering of any of its stock of any class which would constitute a public offering . . . .

Id. § 342(a). In 1968, Pennsylvania adopted close corporation provisions similar to the Delaware subchapter. PA. STAT. ANN. tit. 15, §§ 1371–86 (Supp. 1975). The Maryland close corporation provisions, enacted in 1967, merely define the close corporation as a corporation whose charter contains "a statement that the corporation is a close corporation" and, unlike Delaware, do not require the corporation to restrict the number of shareholders. MD. ANN. CODE art. 23, §§ 100–11 (1973).

Massachusetts has enacted no statutory definition of the close corporation, either in the form of a separate statute, or as a subchapter to its general corporation statute.

Many states have provided statutory modifications for the purpose of accommodating the close corporation. 1 O'NEAL, *supra* note 39, § 1.14; *see, e.g.,* CAL. CORP. CODE § 819 (West Supp. 1975) (authorizing court appointment of a provisional director in case of director deadlock); DEL. CODE ANN. tit. 8, § 101 (1975) (permitting the corporation to be formed by a single incorporator); ILL. ANN. STAT. ch. 32, § 157.34 (Smith-Hurd Supp. 1975) (authorizing the corporation to have less than the traditional minimum of three directors).

For commentaries on the need for legislation covering close corporations, *see* Bradley, *Toward a More Perfect Close Corporation — The Need for More and Improved Legislation,* 54 GEO. L.J. 1145 (1966); O'Neal, *Recent Legislation Affecting Close Corporations,* 23 LAW & CONTEMP. PROB. 341 (1958); Weiner, *Legislative*

all close corporations appear to have at least two features in common:[51] 1) restricted alienability of shares;[52] and 2) integration of ownership and management.[53] However, there are varying shades within the close corporation spectrum which give rise to characteristically different corporate entities, all defined as close corporations: the one-man corporation, the incorporated partnership, the family corporation, and the large, complex, but still closely held corporation.[54] By adopting a sweeping definition of the close corporation, it appears that the *Donahue* court has overlooked these various nuances existing within the close corporation setting.

The court described the close corporation as having a "small number of stockholders."[55] This description is unfortunately susceptible to an infinite variety of interpretations, and provides Massachusetts corporations with no particular guidelines to determine whether they fall within the purview of the court's definition of a close corporation.[56] For example, a

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Recognition of the Close Corporation, 27 MICH. L. REV. 273 (1929); Note, *Statutory Assistance for Closely Held Corporations*, 71 HARV. L. REV. 1498 (1958); Note, *A Plea for Separate Statutory Treatment of the Close Corporation*, 33 N.Y.U.L. REV. 700 (1958).

51. *See* 1 O'NEAL, *supra* note 39, § 1.07, at 21 (enumerating as other characteristics of most close corporations a small number of shareholders, and a familiarity among shareholders with the business capabilities of one another).

52. Hornstein, *Stockholders' Agreements in the Closely Held Corporation*, 59 YALE L.J. 1040, 1047–48 (1950). Restrictions imposed upon the transferability of shares in close corporations serve as an example of the judicial tolerance of the departure by the close corporation from the traditional corporate norm of free alienability of shares. Absolute restrictions on transferability of shares will be declared void as against public policy. *Id.* at 1048. Judicially acceptable transfer restrictions have included the prohibition of sale to an outsider unless the shares are first offered to the corporation or its shareholders. This restriction, known as a "first option" provision, grants a preemptive right to the corporation or its shareholders to the shares offered for sale. *Id.* For comprehensive treatment of the subject of transfer restrictions, *see* Cataldo, *Stock Transfer Restrictions and the Closed Corporation*, 37 VA. L. REV. 229 (1951).

53. 1 O'NEAL, *supra* note 39, § 1.07, at 21–22.

54. At one end of the close corporation spectrum may be found the one-man corporation, in which all the stock is controlled by a single shareholder. 1 O'NEAL, *supra* note 39, § 1.05. *See generally* Fuller, *The Incorporated Individual: A Study of the One-Man Company*, 51 HARV. L. REV. 1373 (1938). Another species of the close corporation has often been called the "joint venture corporation" or the "incorporated partnership." This species is an outgrowth of a relationship between several persons who are partners or joint venturers in a business and subsequently decide to incorporate to obtain the benefits of incorporation. 1 O'NEAL, *supra* note 39, §§ 1.06–.06b. A family corporation is one in which the stock is controlled by the members of one family. *Id.* § 1.05. At the opposite end of the close corporation spectrum lie the corporate giants similar to Ford Motor Company, which was a close corporation until 1955, when it made its first public offering of shares. *Id.* § 1.03.

55. ___ Mass. at ___, 328 N.E.2d at 511.

56. Though it is arguable that the court has also failed to provide guidelines as to what constitutes "substantial majority stockholder participation in the management, direction and operations of the corporation," this issue is academic in light of the reasoning that any number of majority shareholders who have imposed their will in such a way that the direction of the corporation is controlled must by necessity constitute "substantial" participation. *Id.*

corporation composed of 50 persons, who have agreed not to sell their shares to others,[57] and whose majority shareholders are active participants in the management of the corporation, may be justifiably concerned as to the impact of *Donahue* upon its controlling shareholders. While 50 shareholders may be a small number compared to the number of General Motors shareholders, it may not be small when compared to the number of shareholders in the average American corporation.[58]

The confusion thus generated by *Donahue* is potentially dangerous in light of the extreme fiduciary obligation it imposes upon close corporation shareholders. What is perhaps most hazardous is dicta in *Donahue* that this stringent fiduciary duty should be imposed upon shareholders in their actions relative to *all* corporate operations which affect the "rights and investments of other stockholders."[59] Justice Wilkins, in his concurring opinion, stressed that he was not in agreement with such a broad imposition of this strict fiduciary standard, and suggested that the imposition of this duty should be restricted to the corporate share repurchase situation.[60] The implication thus raised by *Donahue* leaves other areas of corporate activity such as declaration of dividends,[61] sale of treasury

57. For a discussion of shareholder stock transfer agreements, *see* 2 O'NEAL, *supra* note 39, §§ 7.08–.10. Shareholder agreements are also used to delineate methods of resolving disputes, procedures for declaring dividends, and other corporate control devices. 1 *id.* § 5.02. The minority shareholder in the close corporation will frequently try, through the vehicle of a shareholder agreement, to secure representation in management positions. *Id. See generally* Hancock, *supra* note 38, at 137–40; Hornstein, *supra* note 52.

58. *See* 1 O'NEAL, *supra* note 39, § 1.02.

59. ____ Mass. at ____ n.18, 328 N.E.2d at 515 n.18. The court stressed that the stockholder's strict fiduciary duty arose "relative to the operations of the enterprise." *Id.*

60. *Id.* at ____, 328 N.E.2d at 521 (Wilkins, J., concurring). Justice Wilkins felt that the court had proceeded beyond the facts of this case in its sweeping imposition of a stringent fiduciary duty in all corporate operations. He cautioned that on other facts, the "analogy to partnerships may not be a complete one." *Id.*

61. The courts generally accord directors a wide range of discretion in making the determination of whether or not to declare a dividend. In Fernald v. Frank Ridlon Co., 246 Mass. 64, 140 N.E. 421 (1923), the Supreme Judicial Court of Massachusetts stated that this "discretion will not be interfered with by the courts unless the directors act fraudulently or unreasonably." *Id.* at 71, 140 N.E. at 425. Several years later, in Daniels v. Briggs, 279 Mass. 87, 180 N.E. 717 (1932), where a minority shareholder in a close corporation brought suit against the corporation's majority shareholder-directors, the court, in refusing to compel declaration of a dividend, noted that judicial interference would not be undertaken except in "extraordinary circumstances." *Id.* at 95, 180 N.E. at 719 (citations omitted).

It is possible that the imposition of *Donahue*'s stringent fiduciary duty upon majority shareholders in a dividend declaration situation such as that presented by *Daniels* would withdraw from the court's determination, in a suit brought to compel declaration of a dividend, subjective factors such as fraud or bad faith, and require only a determination based upon objective criteria such as the availability of a legal source for dividends and the existence of a valid business justification for accumulating profits.

However, *Donahue*'s rationale of maintaining the proportionate interests among shareholders would seem to militate against the imposition of the stringent

stock,[62] determination of salaries, hiring of employees, and other areas traditionally reserved to the discretion of directors, open to investigation by other courts.

By imposing a strict fiduciary duty upon controlling shareholders of a close corporation, the *Donahue* court has provided judicial protection to the often helpless noncontrolling shareholders. However, the uncertainties existing in the court's definition of the close corporation present the shareholders of many Massachusetts corporations with the very real problem of determining whether they could conceivably fall within the grasp of the *Donahue* decision. Until such uncertainties are resolved by future decisions, controlling shareholders should seriously consider whether incorporation in Massachusetts is a prudent choice.

Jane A. Gross

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standard in the dividend declaration situation, as the refusal to declare dividends does not alter proportionate shareholdings. Moreover, *Donahue*'s principle of equality of opportunity among shareholders would be inapposite in the dividend declaration situation, as the refusal by the corporation to declare a dividend would affect all shareholders in the same manner.

However, the imposition of *Donahue*'s strict fiduciary duty in the dividend situation is arguably necessary to protect minority shareholders from the unwarranted accumulation of profits by the majority shareholders seeking to maintain a certain income level at the expense of minority shareholders who are seeking a return on their investment. *See generally* 2 O'NEAL, *supra* note 39, § 8.08.

62. *Donahue*'s requirement of equal opportunity for all shareholders in the close corporation share repurchase situation is strikingly similar to a requirement recently imposed by the New York Court of Appeals in a situation involving the sale of treasury stock. In Schwartz v. Marien, 37 N.Y.2d 487, 335 N.E.2d 334 (1975), a minority shareholder in a close corporation brought an action against the three directors, alleging that, by authorizing the sale of treasury stock to only themselves and two corporate employees and by refusing the plaintiff an equal opportunity to purchase a ratable number of shares, the directors had violated the fiduciary duty owed to the plaintiff. The court held that this preferential treatment accorded the directors and the resulting destruction of the equality of ownership which had previously existed among the shareholders required the directors to justify that the sale of the stock had a bona fide business purpose which could not have been accomplished by other means. *Id.* at 492, 335 N.E.2d at 338. Thus, *Schwartz* required uniform treatment among shareholders as *Donahue* had done. It should also be noted that, as in *Donahue, Schwartz* recognized the existence of a personal right of action in the plaintiff-shareholder in an otherwise classical derivative action situation. The recognition of this personal right of action by courts in jurisdictions having security for costs provisions may significantly aid a minority shareholder in bringing suit.

Since in *Schwartz* the New York court acted without the benefit of the stringent standard adopted by the *Donahue* court, yet awarded strikingly similar relief, it is uncertain whether the *Donahue* duty will lead to a different result in a situation involving the sale of treasury stock. Notwithstanding this result, it is clear that the *Donahue* rationale of equality of treatment is compelling in this context, as similar dangers are inherent in both the *Donahue* and *Schwartz* situations.

FEDERAL COURTS — ABSTENTION — DISMISSAL OF FEDERAL ACTION MANDATED IF PLAINTIFF IS ABLE TO HAVE CLAIM ADJUDICATED IN A PARALLEL STATE PROCEEDING OR IF STATE PROCEEDING IS INSTITUTED AGAINST HIM WHILE FEDERAL CASE IS STILL IN AN EARLY STAGE.

Hicks v. Miranda (U.S. 1975)

Police seized copies of an allegedly obscene film[1] shown in a California theater, and, based upon that evidence,[2] filed a misdemeanor charge against two theater employees for violation of the state's obscenity statute.[3] In a separate proceeding involving both the owners and employees of the theater, the Superior Court of Orange County declared the film obscene under California law and authorized the seizure of any other copies still held by the theater.[4]

In response to these events, the theater owners instituted an action[5] in federal district court[6] to enjoin the enforcement of the obscenity statute,

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1. On the theory that each copy materially differed from the other, four separate seizures were made under warrant. Money in the theater's ticket booth was also seized. Miranda v. Hicks, 388 F. Supp. 350, 353–54 (C.D. Cal. 1974).

2. Each copy of the film formed the basis of a separate count in the criminal complaint filed against each employee. Hicks v. Miranda, 422 U.S. 332, 335 (1975).

3. CAL. PENAL CODE §§ 311 *et seq.* (West 1970).

4. 422 U.S. at 334–36. In the proceedings before the superior court, the owners and employees objected to the court's jurisdiction, purported to "reserve" all federal questions pursuant to the procedure authorized in England v. Louisiana State Bd. of Med. Exams., 375 U.S. 411 (1964), and refused to participate further in the proceedings. The court made the obscenity determination despite those actions. 422 U.S. at 335 & n.2; *see id.* at 336 n.3.

The superior court's decision was not appealed. *Id.* at 336. In a colloquy with one of the federal district judges, counsel for the theater owners indicated that they had decided not to appeal because plaintiffs believed that any appeal would be useless, since the legal questions presented had already been decided adversely by the California courts. *Id.* at 336–37 n.3. During argument before the United States Supreme Court, however, counsel provided a different explanation, asserting that the order was not appealable. *Id.* at 351 n.20.

5. The defendants were the district attorney of Orange County, California, a deputy district attorney, and four members of the local police department. 388 F. Supp. at 354.

6. Jurisdiction was based upon 42 U.S.C. § 1983 (1970), and its jurisdictional counterpart, 28 U.S.C. § 1343(3)–(4) (1970). 388 F. Supp. at 354.

Because of federal justiciability requirements, a plaintiff usually cannot challenge a state penal statute in federal court unless a prosecution against him under that statute is pending or threatened. *See* Steffel v. Thompson, 415 U.S. 452, 458–60 (1974); Boyle v. Landry, 401 U.S. 77 (1971); Younger v. Harris, 401 U.S. 37, 41–42 (1971); Comment, *Protecting Civil Liberties Through Federal Court Intervention in State Criminal Matters,* 59 CALIF. L. REV. 1549, 1561–62 (1971) [hereinafter cited as *Protecting Civil Liberties*]; Comment, *Federal Declaratory Relief from Unconstitutional State Statutes: the Implications of* Steffel v. Thompson, 9 HARV. CIV. RIGHTS-CIV. LIB. L. REV. 520, 526–33 (1974) [hereinafter cited as *Implications of* Steffel]; Note, *Declaratory Relief in the Criminal Law,* 80 HARV. L. REV. 1490, 1507–09 (1967); *cf.* Note, *Implications of the* Younger *Cases for the Availability of Federal Equitable Relief When No State Prosecution Is Pending,* 72 COLUM. L. REV. 874, 893–94 (1972) [hereinafter cited as *Implications of the* Younger *Cases*]. No such prosecution was

to have sections of the statute[7] declared unconstitutional,[8] and to reacquire the seized films.[9] A three-judge court was convened to consider the federal complaint.[10] Meanwhile, one day after service of that complaint was completed, the state criminal complaint against the theater employees was amended to include the federal plaintiffs (plaintiffs) and to add counts alleging conspiracy.[11]

Reaching the merits of the controversy,[12] the three-judge court[13] declared that the California obscenity statute was unconstitutional[14] and ordered that the seized property be returned.[15] That ruling was directly appealed to the Supreme Court of the United States,[16] which reversed,[17]

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present when the theater owners commenced their action. *See* note 63 *infra*. Nevertheless, the action was justiciable because theater property had been seized and held by the state officials for the sole reason that the theater owners had allegedly violated the attacked statute. 388 F. Supp. at 355.

7. CAL. PENAL CODE §§ 311, 311.2, 311.5 (West 1970).

8. *See* Federal Declaratory Judgment Act, 28 U.S.C. §§ 2201–02 (1970).

9. 422 U.S. at 337–38.

10. *Id.* The Judicial Code requires that federal challenges to the enforcement of a state statute by a state official be heard and determined by a three-judge district court. 28 U.S.C. § 2281 (1970).

Before the three-judge court was convened, a federal district court, having found insufficient proof of irreparable injury and an insufficient likelihood that plaintiffs would prevail on the merits, denied a request by plaintiffs for a temporary restraining order. 422 U.S. at 338. Subsequently, a motion by plaintiffs for a temporary injunction to restrain the enforcement of both the obscenity statute, CAL. PENAL CODE §§ 311 *et seq.* (West 1970), and the California search warrant statute, CAL. PENAL CODE §§ 1523–42 (West 1970), was also denied. 422 U.S. at 338–39 & n.6.

11. 422 U.S. at 338–39.

12. The three-judge court rejected a contention that the doctrines of Younger v. Harris, 401 U.S. 37 (1971), and Samuels v. Mackell, 401 U.S. 66 (1971), required it to abstain from deciding the case on its merits and awarding appropriate relief. Instead, relying on Steffel v. Thompson, 415 U.S. 452 (1974), the court held that *Younger* and *Samuels* were not applicable when no prosecution was pending against the plaintiffs personally at the time that the federal complaint was filed and that it was therefore not required to abstain from examining the merits of the plaintiffs' declaratory judgment action. 388 F. Supp. at 356, 361–62. Additionally, the court found that a grant of injunctive relief was appropriate because plaintiffs' injury would probably not be remedied by a defense in the state criminal prosecution since the California courts had previously declared the state obscenity statute constitutional. *Id.* at 360; *see* People v. Enskat, 33 Cal. App. 3d 900, 109 Cal. Rptr. 433 (1973), *hearing denied*, 33 Cal. App. 3d 916 (Cal., Oct. 24, 1973), *cert. denied*, 418 U.S. 937 (1974). Alternatively, the court asserted that the repeated seizures of the film and cash receipts and the naming of the plaintiffs as criminal defendants after the federal suit had been filed demonstrated bad faith and harassment which justified federal intervention under an exception to the *Younger* rule. 388 F. Supp. at 360, 361–62. For a discussion of the bad-faith exception to the *Younger* rule, *see* note 17 *infra*.

13. Two opinions were issued by the three-judge court, the second in response to various post-judgment motions filed by the defendants. *See* 388 F. Supp. at 352, 360. The opinions were reported together.

14. *Id.* at 356–59.

15. *Id.* at 360, 364–65. The order required the federal defendants to petition the state court for the return to the plaintiffs of three copies of the film; it was agreed that the state officials could retain the other seized copy. *See id.* at 364–65. The seized money was returned by mutual agreement. *Id.*

16. *See* 28 U.S.C. § 1253 (1970); note 40 *infra*.

17. In addition to holding that policy considerations compelled the application of the abstention rule announced in Younger v. Harris, 401 U.S. 37 (1971), the Court

holding that the three-judge court had erred in reaching the merits of the case and should have dismissed the action because 1) the plaintiffs had a substantial interest in the state proceedings which were already underway and which could provide an adequate forum for the presentation of their claims and 2) state criminal proceedings had been instituted against the plaintiffs "before any proceedings of substance on the merits"[18] had occurred in the federal court. *Hicks v. Miranda,* 422 U.S. 332 (1975).

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explicitly disapproved the district court's alternative holding that the state officials' actions constituted bad faith and harassment which would have brought the case within an exception to the *Younger* doctrine's application. Characterizing the district court's findings on that issue as "vague and conclusory," the majority concluded that the district court had derived its holding from its decision that the state obscenity statute was unconstitutional. 422 U.S. at 350–52. The reasoning of the three-judge court — that the officials were guilty of bad faith and harassment because they had used an unconstitutional statute to frustrate the plaintiffs' constitutionally protected activity — was incorrect, since the statute had not been declared invalid at the time the officials acted, and since each of the officials' actions had been authorized by judicial warrant or order. *Id.* at 351–52. Although evidence obtained in some of the early seizures had been suppressed in the municipal court, that suppression order had been reversed. *Id.* at 339–41 & n.9. Therefore, absent a showing that the state officials were not entitled to rely on those judicial authorizations, no bad faith could be found. The Court concluded that an ex post facto determination of bad faith based upon a finding of unconstitutionality would allow *Younger* to "be swallowed up by its exception." *Id.* at 350–52.

The scope of the exceptions to the *Younger* rule has not yet been fully defined. *See generally* Kugler v. Helfant, 421 U.S. 117, 123–25 & n.4 (1975). The presence of bad faith and harassment by state officials constitutes one of those exceptions because the officials' indifference to the outcome of the state proceedings renders the availability of the state forum to the plaintiff virtually useless. *See* Note, *I Used to Love You but It's All Over Now: Abstention and the Federal Courts' Retreat from Their Role as Primary Guardians of First Amendment Freedoms,* 45 S. CAL. L. REV. 847, 879–80 (1972) [hereinafter cited as *The Federal Courts' Retreat*]. *See generally* Allee v. Medrano, 420 U.S. 802, 833–46 (1974) (Burger, C.J., concurring in part and dissenting in part). In this context, the factual test of bad faith requires that the state prosecution have actually been instituted without a reasonable expectation of a valid conviction. Kugler v. Helfant, 421 U.S. 117, 124, 126 n.6 (1975) (decided subsequent to three-judge court's decision in *Hicks*); Perez v. Ledesma, 401 U.S. 82, 85 (1971); Cameron v. Johnson, 390 U.S. 611, 619–20 (1968). An analysis of the facts presented in *Hicks* discloses that the Court was correct in concluding that that test had not been met. The three-judge court had inferred bad faith from the various seizures and criminal prosecutions. *See* 388 F. Supp. at 360, 361–62. Ironically, however, that course of action had demonstrated the exact opposite: the officials, zealous in their efforts to successfully enforce the obscenity law, had no reason to believe that they could not do so. The officials' actions had been authorized under the law as they knew it; the subsequent declaration by the district court that the statute was unconstitutional and, hence, unenforceable, could not logically have been imputed to the knowledge of those officials to discredit their reasonable expectations. In retrospect, this error of the district court can best be explained as the result of a misplacing of the burden of proof. The district court's inference of bad faith had been based primarily upon the state prosecutors' failure to explain their timing of the institution of state criminal proceedings against the plaintiffs. *See id.* at 361–62. Hence, it presumed bad faith until the state could prove otherwise. But the burden should have been placed on the plaintiffs, not on the state. *See, e.g.,* Younger v. Harris, 401 U.S. 37, 54 (1971). An analysis based upon a proper transposition of that burden of proof reveals that the party correctly charged therewith had failed to demonstrate the presence of bad faith.

18. 422 U.S. at 349.

The dismissal in *Hicks* was an exercise of the federal doctrine of abstention. Generally, this doctrine states that the federal courts should, in their equitable discretion, refuse to decide certain cases, requiring the cases instead to be initially decided in state tribunals.[19] In one application of this doctrine, referred to in this note as "*Younger* abstention,"[20] the federal judiciary has refused to exercise its injunctive powers to enjoin state criminal proceedings which are threatened[21] or have already commenced.[22] In the principal case articulating this policy, *Younger v. Harris*,[23] the United States Supreme Court explained that this application of federal abstention was based upon the general notion of comity[24] and equity's

19. *The Federal Courts' Retreat, supra* note 17, at 847, 849. *See generally* C. WRIGHT, HANDBOOK OF THE LAW OF FEDERAL COURTS § 52 (2d ed. 1970); Field, *Abstention in Constitutional Cases: the Scope of the* Pullman *Abstention Doctrine,* 122 U. PA. L. REV. 1071 (1974).

The abstention doctrine did not begin to evolve in the federal courts until early in the 20th century. *See* Maraist, *Federal Injunctive Relief Against State Court Proceedings: the Significance of* Dombrowski, 48 TEXAS L. REV. 535, 537–38 (1970). However, manifestations of a similar philosophy had existed from the time of the Nation's inception. The eleventh amendment to the Constitution of the United States, for example, had been interpreted to prohibit the federal courts from adjudicating any suit by a citizen of a state against any state or against officials of any state who were acting in their official capacity. Hans v. Louisiana, 134 U.S. 1 (1890); Governor of Georgia v. Madrazo, 26 U.S.(1 Pet.) 110 (1828). The Supreme Court, however, subsequently declared that a state official's performance of an unconstitutional act is per se ultra vires and thus not within his constitutionally protected capacity. *See Ex parte* Young, 209 U.S. 123 (1908). That decision placed the *Hicks* type of action outside the constitutional prohibition. *See generally* C. WRIGHT, *supra* § 48.

Similarly, a statutory prohibition against the enjoining of state court proceedings had existed since 1793. *See* Federal Anti-Injunction Act, Act of March 2, 1793, ch. 22, § 5, 1 Stat. 334, 335 (now 28 U.S.C. § 2283 (1970)). However, because the *Hicks* case was a proceeding under 42 U.S.C. § 1983 (1970), it fell within an exception to that Act's application. *See* Mitchum v. Foster, 407 U.S. 225 (1972).

20. The abstention doctrine takes a variety of forms according to the factual situation to which it is applied, the rationale used to justify its application, and the procedural consequences which result from its use. *See* C. WRIGHT, *supra* note 19, § 52; Field, *supra* note 19, at 1147–87. This casenote deals with just one category of the doctrine, referred to herein as "*Younger* abstention," after the name of the principal case in the area, Younger v. Harris, 401 U.S. 37 (1971).

21. Douglas v. City of Jeannette, 319 U.S. 157 (1943). *Douglas* held that, in their equitable discretion, federal courts should allow state courts to try state criminal cases without federal interference unless the federal plaintiff was able to show "irreparable injury 'both great and immediate.'" *Id.* at 164, *quoting* Spielman Motor Sales Co. v. Dodge, 295 U.S. 89, 95 (1935). The Court explained that "[n]o person is immune from prosecution in good faith for his alleged criminal acts" and that the constitutionality of a criminal statute could just as readily be determined in a state criminal case as in a federal suit for injunctive relief. 319 U.S. at 163.

22. Stefanelli v. Minard, 342 U.S. 117, 122–23 (1951). In *Stefanelli,* the considerations discussed in *Douglas* were held even more cogent where state criminal proceedings were already pending, rather than merely threatened. *Id.*

23. 401 U.S. 37 (1971). *Younger* was the primary case in a group of abstention cases decided by the Court in 1971. The others were Samuels v. Mackell, 401 U.S. 66 (1971); Boyle v. Landry, 401 U.S. 77 (1971); Perez v. Ledesma, 401 U.S. 82 (1971); Dyson v. Stein, 401 U.S. 200 (1971) (per curiam); and Byrne v. Karelexis, 401 U.S. 216 (1971) (per curiam).

24. 401 U.S. at 44. As an inherent aspect of the federal system, that notion required that legitimate state functions be properly respected by the federal government and its courts. *Id.*

recognition of the plaintiff's adequate remedy at law in the state court proceedings.[25] In this situation, therefore, unless the plaintiff could demonstrate a bad faith prosecution by state officials or other extraordinary circumstances rendering adequate vindication of his constitutional claim impossible in the state criminal proceedings, federal relief had to be denied.[26] In the companion case of *Samuels v. Mackell*,[27] those same considerations were also held applicable to a grant of declaratory relief when a state prosecution is pending.[28]

The analysis to be applied when no state court prosecution is pending was subsequently articulated[29] by the Supreme Court in *Steffel v. Thompson*.[30] The plaintiff in *Steffel* sought federal declaratory relief from a threatened state criminal prosecution, but, since no prosecution had actually been initiated against him, *Samuels* was held inapposite. Proclaiming that "the relevant principles of equity, comity, and federalism 'have little force in the absence of a pending state proceeding,' "[31] the Court explained that the lack of such a proceeding could leave the plaintiff with no forum other than a federal court in which to test his constitutional claim unless he chose to actually instigate prosecution by violating the state law.[32] Given this lack of an available forum, the interest of the federal courts in serving as primary guardians of federal constitutional rights[33] became a prime factor for consideration,[34] and, as a result, federal declaratory relief was appropriate.[35] The propriety of granting injunctive relief in such a situation was left undecided.[36] The Court thus developed a dichotomous ap-

25. *Id.* at 43–44.

26. *Id.* at 48–49, 53–54; *see* Kugler v. Helfant, 421 U.S. 117, 123–25 (1975). Although in some cases a court may retain jurisdiction after it has invoked the abstention doctrine, the court will dismiss the action if the interests of comity are so strong as to override the need for providing a federal forum. *Younger* abstention is one of the situations in which dismissal is proper. *See* Field, *supra* note 19, at 1163–87; *The Federal Courts' Retreat, supra* note 17, at 849–53.

27. 401 U.S. 66 (1971).

28. In *Samuels*, the Court reasoned that a declaratory judgment would be as equally disruptive of pending state proceedings as would be an injunction because a court could compel a subsequent injunction to secure the judgment's enforcement under the Federal Declaratory Judgment Act, 28 U.S.C. § 2202 (1970), and also because the judgment carried a res judicata effect which would render continuation of the state prosecution impossible. 401 U.S. at 72–73.

29. *Younger* and *Samuels* had expressly left the issue open. *See* Younger v. Harris, 401 U.S. 37, 41 (1971); Samuels v. Mackell, 401 U.S. 66, 73–74 (1971).

30. 415 U.S. 452 (1974), *noted in* 20 VILL. L. REV. 241 (1974).

31. *Id.* at 462, *quoting* Lake Carriers' Ass'n v. MacMillan, 406 U.S. 498, 509 (1972).

32. 415 U.S. at 462. The Court also noted that in such a situation legal proceedings would not be duplicated, state criminal proceedings would not be disrupted, and "federal intervention [could not] be interpreted as reflecting negatively upon the state court's ability to enforce constitutional principles." *Id.*

33. *See* notes 73–75 and accompanying text *infra*.

34. 415 U.S. at 463.

35. *Id.* at 472–73, 475.

36. *Id.* at 463, 475. The Court did emphasize, however, that, when a proceeding was not already pending, a grant of injunctive relief was not to be treated identically

proach to the abstention issue, recognizing an overriding state interest requiring abstention when a state criminal proceeding[37] was pending, but also recognizing the absence of such an interest when no state action was pending.

Against this background, the Supreme Court,[38] with four of its members dissenting,[39] held that the *Younger* abstention doctrine compelled dismissal in *Hicks v. Miranda.*[40] It first considered the application of the doctrine to the facts existing at the time that the federal complaint had been filed. Noting that at that time state proceedings had not yet been instituted against the plaintiffs themselves, the majority emphasized that the plaintiffs nevertheless had possessed a substantial interest in those state proceedings which were then extant: state criminal charges had been brought against plaintiffs' employees; moreover, plaintiffs' property had been seized, and their film had been declared obscene and subject to further seizure.[41] The federal relief which the plaintiffs had sought would necessarily have interfered with the pending prosecution of their employees.[42] The interests of the plaintiffs and their employees had been closely intertwined, even to the point that both were represented by the same counsel.[43] Given that situation, the Court would not allow the *Younger* doctrine to be circumvented merely because no criminal prosecu-

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to a grant of declaratory relief, the requirements for a grant of injunctive relief remaining much more stringent than those for a declaratory judgment. *Id.* at 462–73.

Six days after its decision in *Hicks,* the Court decided that preliminary injunctive relief could be granted if no state proceedings were already pending. Doran v. Salem Inn, Inc., 422 U.S. 922 (1975).

37. The Court recently extended the *Younger* rule to certain noncriminal proceedings. *See* Huffman v. Pursue, Ltd., 420 U.S. 592 (1975). In that case the Court also added an exhaustion aspect to the rule, requiring that all available state appellate procedures be utilized before recourse to the federal courts could be had. *Id.* at 607–11.

38. The opinion of the Court was delivered by Justice White. 422 U.S. at 334. Chief Justice Burger joined in that opinion and also wrote a brief concurrence in which he discussed the composition of the three-judge court. *See id.* at 352–53 (Burger, C.J., concurring).

39. The dissent was written by Justice Stewart, and was joined by Justices Douglas, Brennan, and Marshall. *Id.* at 353.

40. Before reaching the abstention issue, the Court dealt at length with two challenges to its appellate jurisdiction under section 1253 of the Judicial Code, 28 U.S.C. § 1253 (1970), which grants jurisdiction only for actions required to be heard by three-judge courts. It first held that the plaintiffs' challenge to the search warrant statute (*see* note 10 *supra*) preserved the Court's jurisdiction to decide the abstention issue although, as a result of the decision in Miller v. California, 418 U.S. 915 (1974), the issue of the obscenity statute's constitutionality no longer presented a substantial federal question and thus did not require adjudication by a three-judge court. 422 U.S. at 343–46. *See generally* Bailey v. Patterson, 369 U.S. 31 (1962) (per curiam). Secondly, the Court rejected the appellee's contention that the three-judge court's injunction was of a type not directly appealable under section 1253. 422 U.S. at 347–48.

41. 422 U.S. at 348.

42. The three-judge court had permitted the state officials to retain only one copy of the film. *See* note 15 and accompanying text *supra.* By thus prohibiting use of the other copies as evidence, that order severely hampered prosecution of several counts in the criminal complaint against the employees. 422 U.S. at 347; *see* note 2 and accompanying text *supra. See also* note 1 *supra.*

43. 422 U.S. at 348–49.

tion was personally pending against the plaintiffs on the date that their federal complaint had been filed. Since the plaintiffs were unable to clearly demonstrate that their constitutional claims and property interests could not be adequately advanced during the state prosecution of their employees,[44] the considerations of comity emphasized in *Younger* required abstention by the federal courts.[45]

Secondly, the Court discussed the impact of the institution of the state proceedings against the plaintiffs themselves. Noting that that event occurred only a day after service of the federal complaint had been completed, the Court stressed that, despite the formulation in *Steffel* of a rule focusing upon the pendency of a state prosecution, the exact stage of the federal proceeding at which pendency of the state action would be dispositive of the abstention question had yet to be identified.[46] The Court held that the critical determination of whether a state proceeding was already pending would not be made as of the date that the federal complaint had been filed; instead, the *Younger* abstention doctrine would continue to apply until "proceedings of substance on the merits" took place in the federal court.[47] Since the plaintiffs had been criminally charged before answers had been filed in the federal case and before any proceedings had occurred before the three-judge court, no proceedings of substance on the merits had yet occurred, and dismissal was therefore mandated. A contrary ruling would have only served to "trivialize" the principles of *Younger*.[48]

It was with this second portion of the Court's opinion that the dissenters disagreed. In their view, resolution of the abstention issue required an evaluation of the state and federal interests as they had existed when the state proceeding against the plaintiffs had been commenced. Citing *Steffel*, they pointed out that no substantial state interests requiring abstention had existed at the time that the federal proceeding had been instituted since no state prosecution was pending against the plaintiffs at that time. They added that, when the state prosecution of plaintiffs was subsequently begun, the federal interest in adjudicating and vindicating

44. The federal plaintiffs had successfully argued in the district court that a presentation of their constitutional claim in the California courts would have been fruitless, since those courts had already settled the issue against them. *See* note 12 *supra*. The Supreme Court disagreed. Noting that the state ruling had been made by an intermediate appellate court, the Court emphasized that the California Supreme Court could have been asked to reconsider the issue, that "[s]tate courts, like other courts, sometimes change their minds," and that, even if the state courts adhered to their position, United States Supreme Court review would always be available. Thus, *Younger* was "not so easily avoided." 422 U.S. at 350 n.18.

45. 422 U.S. at 349.

46. *Id.*

47. *Id.*

48. *Id.* at 349–50. Disposing of the case in this manner allowed the Court to sidestep the additional issue of whether the plaintiffs' failure to appeal the state superior court's ruling that their films were obscene required dismissal of the federal case under Huffman v. Pursue, Ltd., 420 U.S. 592 (1975). *See* 422 U.S. at 351 n.20. That decision would have depended on whether the state ruling was in fact appealable. *See* note 37 *supra*. *See also* note 4 *supra*.

federal constitutional rights had already been invoked. Therefore, the dissent concluded that, since the federalism emphasized in *Younger* required a "sensitivity to the legitimate interests of *both* State and National Governments,"[49] the federal role as primary guarantor of federal constitutional rights should not have been ousted in favor of the state once it had been properly initiated.[50] This analysis compelled the further conclusion that the critical determination of whether a state action was pending should be made as of the time that the federal complaint, with its concomitant invocation of the substantial federal interest in adjudicating the proceedings, was filed.[51] The majority's new rule was interpreted to hold that *Steffel* was "inoperative" if a state charge were filed up to some unclear[52] later point in time, and this, it was said, actually "trivialized" *Steffel.*[53]

Conscious of the decision's impact, the dissenters predicted a more unseemly "race to the courthouse" to determine controlling jurisdiction[54] than the mere pendency dichotomy could itself ever ensure, since the states could now "leave the mark later, run a shorter course, and arrive first at the finish line."[55] The majority's decision invited state prosecutors to institute state proceedings in order to remove a case from federal jurisdiction to a more sympathetic state forum; it "virtually [instructed] state officials to answer federal complaints with state indictments."[56] Thus, the majority opinion was considered a major distortion of the federal balance reflected in past decisions, being untrue not only to *Steffel,* but to the principles of *Younger* as well.[57]

The dissenters thus pointed out the major difficulty in reconciling the second portion of the majority's opinion with the abstention doctrine analysis established by previous cases. Both *Younger* and *Samuels* had emphasized that federal abstention was mandated when a state proceeding had been commenced prior to the initiation of a federal suit.[58] Moreover, the Court had justified its holding in *Steffel* by noting that no state proceedings were pending at the time that the federal complaint had been filed.[59] Though dicta, those statements were consistent with the dichotomy

49. 422 U.S. at 356–57 (Stewart, J., dissenting), *quoting* Younger v. Harris, 401 U.S. 37, 44 (1971) (emphasis supplied by dissent in Hicks).

50. 422 U.S. at 353–57.

51. *See id.*

52. *See* notes 98 & 99 and accompanying text *infra.*

53. 422 U.S. at 353.

54. Under the form of the doctrine favored by the dissenters, the determination of whether state or federal jurisdiction was appropriate would necessarily be made according to which action was filed first. Thus, the party who won the "race to the courthouse" would be rewarded with his choice of a judicial forum. *See* Dombrowski v. Pfister, 380 U.S. 479, 502 (1965) (Harlan, J., dissenting).

55. 422 U.S. at 354.

56. *Id.* at 357.

57. *Id.*

58. *See* Younger v. Harris, 401 U.S. 37, 41 (1971); Samuels v. Mackell, 401 U.S. 66, 72–74 (1971).

59. 415 U.S. at 462. The three-judge court relied heavily upon this language. *See* 388 F. Supp. at 361.

which had been developed, and they were interpreted as a clear expression of the Court's approach to the abstention problem.[60] Thus, though not actually in conflict with earlier holdings,[61] the declaration in *Hicks* that *Younger* abstention would apply even though state proceedings had not been instituted until after the filing of the federal complaint[62] was inconsistent with previous statements of the Court and blurred what theretofore had seemed to be a clear rule.[63]

More important than the Court's rejection of its own dicta, however, was the question of whether the majority opinion was consistent with the analysis suggested in *Steffel.* In *Steffel,* the Court had declared that substantial weight should be accorded the fact that Congress had made the federal courts "the primary guardians of constitutional rights" and that that factor would control in the absence of a pending state proceeding.[64] That declaration formed the basis for the dissenters' argument[65] that an assertion of such a major federal interest, once invoked by the filing of a federal claim, could not be ousted by the subsequent presence of a pending state proceeding because such an ouster would violate the deference to which that legitimate federal interest was entitled. Arguably, since "[f]ederalism is not a one-way street,"[66] the converse of *Younger*'s comity

60. *See Implications of* Steffel, *supra* note 6, at 535–36.

61. The Court had once summarily affirmed the issuance of a temporary injunction although a state prosecution against the federal plaintiff had been instituted on the day after the federal complaint had been filed. *See* Nichol v. Keenan, 404 U.S. 1055 (1972), *aff'g mem.* 326 F. Supp. 613 (W.D. Wis. 1971). Yet, despite its factual similarity to *Hicks, Nichol* is distinguishable. The only question presented on appellate review of the grant of a preliminary injunction is whether the district court abused its discretion in issuing the order; the appellate court does not decide the merits of the questions presented by the case. Doran v. Salem Inn, Inc., 422 U.S. 922, 931–32, 934 (1975). Therefore, the Court in *Nichol* only decided that, given the state of the law in 1972, the district court had not abused its discretion in issuing the injunction. The Court did not consider the abstention issue itself. *But cf. Implications of* Steffel, *supra* note 6, at 537–38 (discussing trial court opinion).

62. *See* notes 46–48 and accompanying text *supra.*

63. It should be noted that *Hicks* only decided the stage of a federal action during which a state proceeding had to be pending in order for *Younger* abstention to apply; it did not define when a state proceeding should be considered "pending." On the latter issue, decisions have run the gamut from the time application is made for a search warrant to the time of the state trial. *See Federal Injunctions Against State Criminal Proceedings,* 4 STAN. L. REV. 381, 388–89 (1952); *The Supreme Court, 1970 Term,* 85 HARV. L. REV. 3, 308–09 (1971); 20 VILL. L. REV. 241, 251 & n.82 (1974). No one in *Hicks* contended that the amendment of the state's criminal complaint to include the federal plaintiffs did not create a pending proceeding against those plaintiffs.

It should also be emphasized that the situation in *Hicks* did not involve a plaintiff who, after instituting his federal action, continued his unlawful conduct, thus inviting a subsequent state prosecution. In such cases, at least so long as the federal litigation is still "in an embryonic stage [with] no contested matter [having] been decided," the *Younger* doctrine fully applies. Doran v. Salem Inn, Inc., 422 U.S. 922, 929 (1975) (case decided subsequent to, but without citation to, *Hicks*).

64. Steffel v. Thompson, 415 U.S. 452, 463 (1974), *quoting* Perez v. Ledesma, 401 U.S. 82, 104 (1971) (Brennan, J., concurring in part and dissenting in part); *see* Ellis v. Dyson, 421 U.S. 426, 432 (1975); *cf.* Steffel v. Thompson, supra at 472–73.

65. *See* notes 49–53 and accompanying text *supra.*

66. *Implications of* Steffel, *supra* note 6, at 537.

principles should have applied.[67] However, the *Steffel* decision had also recognized that state courts possess an equal responsibility to guard federal constitutional rights.[68] In fact, the underlying basis of that decision had been the absence of an available state forum in which federal constitutional rights could be protected.[69] Therefore, since the initiation of state criminal proceedings made such a forum available in *Hicks,* the Court's mandate of federal abstention was consistent with at least a narrow interpretation of *Steffel*'s rationale.

Of course, although the decision in *Hicks* conformed to the rationale of *Younger* and *Steffel,* its result was not necessarily mandated. The analysis provided by the dissent also would have fit comfortably into the framework of the previous cases. In essence, the difference between the dissent and the majority opinion concerned the proper balance which should be struck between the various interests involved. Although the majority never openly admitted that it was balancing interests,[70] the cases indicate that interests have indeed been balanced against the factors compelling *Younger* abstention.[71] As the dissent pointed out,[72] one interest

67. *See* 422 U.S. at 356–57 (Stewart, J., dissenting).

68. *See* 415 U.S. at 460–61.

69. *Id.* at 462; *see* notes 31–35 and accompanying text *supra; cf.* Kugler v. Helfant, 421 U.S. 117, 124 (1975); Perez v. Ledesma, 401 U.S. 82, 103–04, 120–21 (1971) (Brennan, J., concurring in part and dissenting in part). So long as no state action was pending, the considerations of comity and equitable discretion mandating abstention in *Younger* were absent. Meanwhile, a judicial forum was needed to provide the plaintiff an opportunity to vindicate his constitutional rights. At this point, the interest of the federal courts in serving as primary guardians of constitutional rights took on prime significance and federal judicial relief became appropriate. 415 U.S. at 462–63. Conversely, when a state action was pending, a state judicial forum was already available and a federal forum therefore was not needed. In this context, the considerations of comity and equitable discretion underlying *Younger* outweighed any need for federal intervention. *See* notes 73–76 and accompanying text *infra.*

70. The majority merely asserted that dismissal was mandated in order that the principles of *Younger* not be trivialized. *See* 422 U.S. at 350; notes 46–48 and accompanying text *supra.* It explained those principles in terms of a need to permit state courts to try their cases without federal court interference. *See* 422 U.S. at 349. No countervailing factors were ever mentioned. *See id.* at 349–50.

This approach was consistent with that taken by the cases decided prior to *Hicks.* In *Younger,* for example, the need for a denial of federal relief was explained in terms of the "longstanding public policy against federal court interference with state court proceedings," which was required for reasons of comity and equitable restraint. 401 U.S. at 43–45; *see* notes 45–47 and accompanying text *supra.* Countervailing considerations were not mentioned by the Court. *See* 401 U.S. at 43–54. The *Steffel* opinion was only slightly more cognizant of the balance being struck, basing its holding upon the absence of the considerations of comity and equity which had compelled abstention in *Younger* and then on the countervailing need to provide the plaintiff with a federal forum in which to assert his constitutional claim. 415 U.S. at 462–63; *see* notes 31–34 & 69 and accompanying text *supra. But cf.* Perez v. Ledesma, 401 U.S. 82, 103–21 (1971) (Brennan, J., concurring in part and dissenting in part) (discussing the balancing of interests). On the need for balancing in general, *see* Maraist, *Federal Intervention in State Criminal Proceedings:* Dombrowski, Younger, *and Beyond,* 50 TEXAS L. REV. 1324, 1338–40 (1972).

71. One interest which can be said to have been balanced is the need to provide the plaintiff with *some* judicial forum in which to vindicate his constitutional claim.

which is appropriate for such balancing is that of the federal courts in serving as the primary guarantors of federal constitutional rights,[73] an interest which is so strong that it cannot be overbalanced by the mere availability of a state forum which can also protect those rights.[74] *Steffel* serves as one illustration of the primacy of this interest in the absence of overriding considerations of comity and equity present in a *Younger* situation.[75] Conversely, however, *Younger* implies that when a state prosecution is pending at the time a federal action is commenced, this major federal interest is itself overbalanced by the additional considerations of comity and equity which then become present.[76] The difficult question presented in *Hicks* was whether this overbalancing also occurred when the institution of the federal action antedated the institution of the criminal prosecution by the state. To the dissenters, it did not; since the interest of the federal courts in serving as the guarantor of constitutional rights is "fully implicated from the moment [federal] jurisdiction is invoked,"[77] the interest could not be allowed to be eliminated by the subsequent institution of a state criminal action without allowing it to be totally nullified at the whim of a state prosecutor.[78] To the majority, however, the federal interest apparently was overcome at the time that the subsequent state prosecution was initiated. Only when "proceedings of substance on the merits" took place in the federal action did the federal interest become so strong as to outweigh the factors compelling abstention.[79] This conclusion

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This interest controls when no state action is pending and a state forum is therefore unavailable. In such a situation, provision of a federal forum may be a necessity and the interests in favor of abstention do not override that need. Steffel v. Thompson, 415 U.S. 452 (1974) (by implication); *see* Perez v. Ledesma, 401 U.S. 82, 120 (1971) (Brennan, J., concurring in part and dissenting in part). Because of the institution of the state prosecution in *Hicks*, this interest was not a factor in the case; the state prosecution provided the plaintiffs with a forum for the assertion of their constitutional claim.

72. *See* notes 49–50 and accompanying text *supra*.

73. *See, e.g.*, Zwickler v. Koota, 389 U.S. 241, 245–48 (1967). This interest arose subsequent to the Civil War when Congress ceased relying upon the state courts to vindicate constitutional rights and invested the federal courts with broad powers to redress civil rights deprivations. *Id.*; Steffel v. Thompson, 415 U.S. 452, 463–65 (1974). As a result of this congressional conferral of judicial power, a "duty" was imposed upon the federal judiciary to respect a plaintiff's choice of a federal forum for adjudication of his federal constitutional claims. Zwickler v. Koota, *supra* at 248.

74. *See* Zwickler v. Koota, 389 U.S. 241, 248 (1967).

75. *See* 415 U.S. at 463, 472–73; note 69 *supra*.

76. 401 U.S. 37 (1971) (by implication). This overbalancing is the major difference between *Younger* abstention and the other forms of the abstention doctrine. Because of the interest of the federal courts in protecting constitutional rights, other forms of abstention presume the federal courts to be a proper forum for resolution of a case unless equitable considerations compel a contrary conclusion. On the other hand, where *Younger* abstention is applicable, the overbalancing considerations compelling abstention and dismissal shift the presumption so that the federal forum is presumed not to be proper unless extraordinary circumstances are present. *See* Field, *supra* note 19, at 1163–70.

77. 422 U.S. at 356 (Stewart, J., dissenting).

78. *Id.* at 355–57.

79. *Id.* at 349–50 (by implication).

was never explained by the Court, but it could well be argued that this result occurred because at that point an additional countervailing interest entered the balance — that of judicial economy, with its interest in preventing the waste of precious judicial resources.[80] Thus, it appears that a majority of the Court decided that the interest of the federal courts in serving as primary guarantors of constitutional rights did not in itself overbalance the considerations in favor of *Younger* abstention. Only when other interests were added would the balance tip against a federal court dismissal.

The majority's extension of the time period during which a pending state action could be used to invoke the *Younger* doctrine thus has broad implications. Indeed, it takes on even greater significance in light of the fact that the Court could have based its decision entirely on the narrower rationale of the first portion of its opinion, which discussed what has been called the "parallel plaintiff"[81] problem. Although the dissenters never addressed themselves to this earlier portion of the majority opinion, significant difficulties existed with regard to its line of reasoning. The Court had previously confronted parallel plaintiffs in a *Younger* context in at least two cases. In *Roe v. Wade,*[82] without any specific discussion of the issue, the Court upheld a grant of declaratory relief to a plaintiff challenging a state abortion statute even though a doctor who had entered the case as a plaintiff-intervenor had already been charged with violations of the same statute.[83] Similarly, in *Steffel,* the Court, relying upon *Roe,* held that the plaintiff's federal action was not affected by the fact that a companion of the plaintiff had been prosecuted for the same activity which had been the subject of the plaintiff's federal suit.[84] Nevertheless, in *Hicks,* the Court asserted that the presence of a pending state action against the theater employees served to justify a denial of federal relief to their employers.[85]

An explanation of this apparent inconsistency is suggested by a separate opinion of three members of the *Hicks* majority in *Allee v. Medrano.*[86] In that opinion, Chief Justice Burger discussed the applicability of *Younger* principles where a union derivatively sought federal relief

80. *See* Steffel v. Thompson, 415 U.S. 452, 478 (1974) (White, J., concurring).

81. *See* Note, *Federal Relief Against Threatened State Prosecutions: the Implications of* Younger, Lake Carriers *and* Roe, 48 N.Y.U.L. REV. 965, 980–83 (1973) [hereinafter cited as *Federal Relief*]. Although not fully descriptive, the term was used in that article to describe the situation wherein a party would seek federal relief to restrain the enforcement of a state statute while state proceedings under that statute were already pending against a different party in the state courts.

82. 410 U.S. 113 (1973).

83. *Id.* at 125–27, 166–67. Relying upon *Younger* and *Samuels,* the Court dismissed the doctor's complaint, but this did not affect the grant of relief to another plaintiff, against whom no charges were pending. *See id.*

84. 415 U.S. at 471 n.19.

85. *See* notes 41–45 and accompanying text *supra.*

86. 416 U.S. 802, 821 (1974) (Burger, C.J., joined by White and Rehnquist, JJ., concurring in part and dissenting in part).

from a state statute under which state prosecutions were pending against union members for constitutionally protected organizational activities.[87] He argued that, since the union's cause of action rested solely upon its members' prosecutions, an "identity of interest"[88] existed between the two parties which would justify federal abstention; a denial of federal relief to the union would not deny its prosecuted members a full opportunity to vindicate those same constitutional claims during their own state court proceedings.[89] This factual situation was distinguished from that of *Steffel* in that no such "identity of interest" between that plaintiff and his prosecuted companion which would have allowed the plaintiff's rights to be vindicated in his companion's state prosecution was shown to have existed.[90] The opinion did not articulate guidelines for ascertaining when such an identity of interest would exist, but it noted that "facts of joint activity and common interest" between the two parties would be the determinative factors.[91] By inference, such "joint activity and common interest" must have existed in *Hicks*. The employees of the plaintiffs were prosecuted for the same activities with regard to which federal relief was sought, and the property which the plaintiffs sought to reclaim was the primary evidence in the state prosecution. Moreover, the two parties had retained the same counsel, and their employment relationship assured protection of the plaintiffs' interests in the state action. Therefore, "the same comity considerations"[92] of *Younger* applied.

As a matter of policy, however, the identity-of-interest rule may still be subject to criticism, since it forces a federal plaintiff to arrest conduct which may be constitutionally permissible while awaiting a state determination which might leave the constitutional claim unanswered.[93] Yet, critics must recognize that a similar danger also exists in the classic *Younger* situation itself, in which the state defendant is also the party

87. *See id.* at 829–30 & n.6.

88. *Id.* at 830.

89. *See id.* at 830–31.

90. *See id.* at 831–32. The same analysis apparently distinguishes *Roe*. *Cf.* Doran v. Salem Inn, Inc., 422 U.S. 922, 928–29 (1975).

91. *See* 416 U.S. at 832 n.8 (Burger, C.J., concurring in part and dissenting in part).

92. *Id.* at 831, *quoted in* 422 U.S. at 349.

93. The federal defendant cannot, of course, intervene in the pending criminal action to present his own arguments as to the constitutional issues involved. Meanwhile, even if the state defendant himself decides to present the constitutional claim as a defense, he might, for example, be acquitted on the facts of the case or on some other nonconstitutional ground. *See Federal Relief, supra* note 81, at 982. Indeed, in *Hicks* itself, subsection 311.2(b) of the obscenity statute bestowed a limited criminal immunity on certain theater employees. *See* CAL. PENAL CODE § 311.2(b) (West 1970). The court opinions do not provide sufficient information to indicate whether that immunity was available to the theater employees in *Hicks*, but if it were, it would have enabled them to be acquitted of charges under section 311.2 without a consideration of that section's constitutionality. It also would have posed serious ethical problems for their attorneys, who would still have been charged with vindicating the rights of their other clients, the erstwhile federal plaintiffs, in the state court proceedings.

seeking federal relief.[94] The identity-of-interest rule at least assures that the federal plaintiff and the state defendant have a relationship which is close enough to create a substantial probability that the federal party will have his claims litigated in a state tribunal.[95] Such an opportunity is a "necessary predicate" to *Younger*'s application,[96] but, once it exists, nothing more can be demanded. The *Younger* decision has clearly established that the certainty of resolution of federal claims in a federal court must often be sacrificed to the higher interests of the federal system itself.

The *Hicks* decision has broken new ground in the federal abstention doctrine, and, due to the equivocal language employed by the Court, it may take some time for its holding to assume a definite shape. Its prime impact, of course, will be a broadening of the application of the *Younger* abstention doctrine with a concomitant narrowing of federal judicial authority. Federal district judges can now be expected to scrutinize more closely the principles underlying the *Younger* rule before declaring it inapplicable. As they do so, a clearer formulation of the identity-of-interest rule now applicable to parallel plaintiff situations[97] should begin to evolve. The simple fact that the Court has embraced that rule may have a profound effect on the federal courts' ability to decide a variety of cases involving such potential parallel parties as employers and their employees, corporations and their officers or directors, and labor unions or other unincorporated associations and their members. But the presence of such broad categorical groups should merely alert a court to the rule's possible applicability; it should not be the sole criterion for the rule's application. Instead, the paramount determinants must be the specific facts at hand, for only if they disclose a situation affording the federal plaintiff an opportunity to vindicate his rights in existing parallel state proceedings may the identity-of-interest rule be properly invoked. Similarly, the greater care with which abstention policy will probably now be viewed should produce an effort to determine the exact time period in which the *Younger* rule will control. The Court's new measure of this period — "before any proceedings of substance on the merits have taken place in federal court"[98] — needs

94. For example, the case might be voluntarily dismissed by the state before trial, or, if it does go to trial, the defendant might be acquitted for some reason other than his constitutional defense. *Federal Relief, supra* note 81, at 984.

95. Indeed, the assurance of this interest should serve as the test of whether the rule will apply. If the factual situation will not reasonably assure the federal plaintiff that his interests will be protected in the state proceeding, an identity of interest should, by definition, be found not to exist. *See* text following note 97 *infra.*

96. Huffman v. Pursue, Ltd., 420 U.S. 592, 594 (1975); *see* Gerstein v. Pugh, 420 U.S. 103, 108 n.9 (1975).

97. *See* notes 41–45 & 81–92 and accompanying text *supra.*

98. 422 U.S. at 349. *See also* Doran v. Salem Inn, Inc., 422 U.S. 922, 929 (1975) (implying a time limitation similar to that in *Hicks* for cases wherein a subsequent state prosecution had been instigated by continued unlawful conduct); note 63 *supra.*

The *Hicks* test is apparently two-pronged, requiring the proceedings to be both "of substance" and "on the merits." 422 U.S. at 353 n.1 (Stewart, J., dissenting). Prior to the filing of the state criminal complaint against the theater owners in *Hicks,* the district court, in considering the plaintiffs' request for a preliminary in-

extensive clarification[99] and can be expected to provoke considerable litigation before its meaning is finally settled. It is clear that the rules to be derived from *Hicks* are far from completely formulated.

Of greater concern than the direct impact of *Hicks* on the federal courts, however, is its potential effect on local prosecutors and the dangers which that effect portends for the exercise of federal judicial power. The decision implies that the role of the federal courts as protectors of federal constitutional rights is outweighed, and therefore subject to divestment, by the presence of a state prosecution of the federal plaintiff.[100] As a result, this federal judicial role is in a precarious position. The dissenters' warning that the decision will invite state officials to reply to federal actions by securing state criminal indictments[101] was farfetched. Indeed, "[o]ne need not impugn the motives of state officials to suppose that they would rather prosecute a criminal suit in state court than defend a civil case in a federal forum."[102] Since an indictment is not always required for minor offenses,[103] state officials may not be reluctant to bring state charges to remove a defendant's federal case to the state courts. But the philosophy underlying *Younger* and its progeny does not sanction such conduct. It is imperative that the Court recognize that the filing of state proceedings will not always be prompted by legitimate law enforcement considerations; state officials may seek to frustrate federal jurisdiction, to penalize a plaintiff for having brought a federal action, or to deter others from bringing similar suits.[104] Such motives are certainly not meritorious; yet, no exception to the *Younger* rule would prevent their effectuation so long as state officials might reasonably expect to obtain a valid conviction.[105]

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junction, had made certain preliminary rulings on the merits. *See id.;* note 10 *supra.* Since those proceedings were insufficient to meet the Court's test, they presumably did not satisfy the "of substance" requirement.

99. The Court did not attempt to more clearly define its test in terms of procedural events. In applying the test to the factual situation presented, it merely stated that the plaintiffs "were charged . . . prior to answering the federal case and prior to any proceedings whatsoever before the three-judge court." 422 U.S. at 349–50. That statement may indicate that the issues must be formally joined by both parties through the filing of appropriate documents in order for the test to be met; it may also mean that, if a three-judge court is required to adjudicate the case, any proceedings occurring prior to that court's designation are insufficient. One general consideration which might aid in accurately defining the time period may be the concern for judicial economy. *See* Steffel v. Thompson, 415 U.S. 452, 478 (White, J., concurring); note 80 and accompanying text *supra; cf.* Steffel v. Thompson, *supra* at 462.

100. *See* notes 70–80 and accompanying text *supra.*

101. *See* notes 54–56 and accompanying text *supra.*

102. 422 U.S. at 357 (Stewart, J., dissenting).

103. In *Hicks,* the filing of a criminal complaint was sufficient to institute the state criminal action. A delineation of what other actions may also be sufficient is tied to the difficult problem of defining a "pending" state proceeding. *See* note 63 *supra.* Additionally, as a result of the Court's decision in Huffman v. Pursue, Ltd., 420 U.S. 592 (1975), the mere filing of a state *civil* complaint may adequately institute a pending state action so as to allow the *Younger* abstention doctrine to be asserted. *See* 422 U.S. at 357 (Stewart, J., dissenting). *See generally* note 37 *supra.*

104. *Implications of* Steffel, *supra* note 6, at 534.

105. The major exception, bad faith, is extremely narrow, since it is applicable only in situations wherein the state prosecution is instituted without any supporting

Therefore, the Court should closely study the implications of *Hicks* and decide how and to what extent such unfavorable effects can be limited. Resolution of that particular problem will probably be the next major abstention issue faced by the federal courts.

Hicks v. Miranda presents some serious problems for federal plaintiffs. Through this decision, the Court has extended *Younger's* restrictions on the powers of the federal courts and thereby further strengthened the powers of the states. In so doing, the Court has struck a balance which can well be criticized and has established a rule which is in need of tempering to prevent future abuse. Yet, the delicate task of constitutional balancing which the federal system requires is not an easy one, for through it the Court must strive to preserve values which are fundamental to the American form of government. In that context, *Hicks* presents one additional illustration of the Court's concern with one such fundamental concept: once again the Court has demonstrated its continuing concern for the preservation of American federalism.

Carl A. Solano

FEDERAL INCOME TAXATION — SECTION 1031 NONRECOGNITION OF LIKE KIND EXCHANGES — SALE OF PROPERTY AT ITS FAIR MARKET VALUE CONDITIONED UPON LONG-TERM LEASEBACK FOR FAIR MARKET RENTALS CONSTITUTES A SALE SOLELY FOR CASH CONSIDERATION AND NOT A LIKE KIND EXCHANGE.

Leslie Co. (Tax Ct. 1975)

In 1966, Leslie Company (taxpayer), an industrial manufacturing concern, decided to relocate its business operations and acquired land for that purpose.[1] Financing was necessary in order to construct a new plant, and having explored various methods of financing without success, the taxpayer entered into a sale and leaseback agreement with Prudential Insurance Company of America (Prudential).[2] The agreement provided that following the taxpayer's construction of an industrial plant on the

evidence which could cause the state officials to expect a valid conviction. *See* Maraist, *supra* note 19, at 586–87; Shevin, *Federal Intervention in State Court Proceedings,* 1972 UTAH L. REV. 3, 6; note 17 *supra. See also* Carey, *Federal Court Interference in State Criminal Prosecutions,* 56 MASS. L.Q. 11, 20–21 (1971); *Protecting Civil Liberties, supra* note 6, at 1558. A recognition that there is a greater possibility that state officials are improperly motivated when a state action is instituted subsequent to the filing of a federal complaint may prompt the Court to broaden the bad faith exception in such fact situations and consequently subject the officials' actions to greater scrutiny.

1. Leslie Co., 64 T.C. 247, 249 (1975), *appeal docketed,* No. 75-2305, 3d Cir., Nov. 17, 1975.

2. 64 T.C. at 249.

property according to specifications approved by Prudential, Prudential would purchase the improved property[3] and lease it to the taxpayer for a term of 30 years.[4] The lease was to contain two renewal options of 10 years each and an "option to offer" which gave the taxpayer an option to repurchase the property at specified time intervals in accordance with a declining price schedule.[5]

The taxpayer completed the building, and following approval by Prudential, sold it to Prudential for $2.4 million.[6] The lease agreement was executed contemporaneously with the transfer of title, the rental terms being comparable to the fair rental value of similar properties in the area.[7] The taxpayer reported on its 1968 corporate income tax return a total cost in purchasing the land and erecting the plant of $3.187 million and a resulting loss, after the sale, of $787,414.[8] The Commissioner of Internal Revenue (Commissioner) disallowed the claimed deduction for the loss, contending that the sale and leaseback fell within the nonrecognition provisions of section 1031 of the Internal Revenue Code of 1954 (Code).[9] On petition by the taxpayer, the United States Tax Court rejected the Commissioner's view, *holding* that the transaction was a bona fide sale of the property and not a like kind exchange under section 1031, and, therefore, the general rule of recognition found in section 1002 of the Code[10] was applicable. *Leslie Co.*, 64 T.C. 247 (1975), *appeal docketed*, No. 75–2305, 3d Cir., Nov. 17, 1975.

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3. The agreement provided that the purchase price was to be the actual cost of the land, building, and other improvements, but not to exceed $2.4 million. *Id.*

4. *Id.*

5. If Prudential rejected an offer to purchase, the lease was to terminate. *Id.* at 257 n.2 (Wilbur, J., dissenting).

6. *Id.* at 250.

7. *Id.* The annual rental of $190,560 included all taxes, maintenance, and other charges which the taxpayer was obliged to pay. *Id.*

8. *Id.* at 250–51. The claimed loss resulted in a net operating loss of $366,907 which was carried back to the 1965 tax year. Investment credits of $436.41 and $50,700, which could not be utilized in the 1968 return on account of the net operating loss, were carried back to the 1965 and 1966 tax years respectively. *Id.*

9. *Id.* at 251. Section 1031 of the Code provides in pertinent part:

> (a) NONRECOGNITION OF GAIN OR LOSS FROM EXCHANGES SOLELY IN KIND. — No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.
>
> . . . .
>
> (c) LOSS FROM EXCHANGES NOT SOLELY IN KIND. — If an exchange would be within the provisions of subsection (a) . . . if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

INT. REV. CODE OF 1954, § 1031(a), (c).

10. Section 1002 of the Code provides in pertinent part:

> Except as otherwise provided in this subtitle, on the sale or exchange of property the entire amount of the gain or loss . . . shall be recognized.

Id. § 1002.

Section 1002 of the Code requires that, subject to statutory exceptions, the entire amount of gain or loss on a sale or exchange of property shall be recognized.[11] This gain or loss is generally the difference between the amount realized on the disposition of the property, and the property's adjusted basis.[12] Section 1031 is one of the statutory exceptions contemplated by section 1002. Section 1031(a) provides that no loss or gain shall be recognized in transactions involving the exchange of property, held for productive use in a trade or business or for certain investment purposes, for property of a like kind.[13] If such an exchange also involves the transfer of money or other non-like kind property, section 1031(c) requires recognition of any losses, to the extent of the value of the non-like kind consideration.[14]

The questions involving the application of section 1031 to sale and leaseback transactions did not arise until the mid-1940's when this form of transaction gained popularity.[15] In *Century Electric Co. v. Commissioner*[16] a court first investigated the possibility that a sale conditioned on a long-term leaseback was a nonrecognizable exchange of like kind property within the meaning of section 1031. In *Century Electric,* the taxpayer was denied a loss deduction on a sale and leaseback of its foundry and business property since the transaction, involving a potential 95-year leaseback, was found to be a nonrecognizable exchange of like kind busi-

11. *Id.*

12. *Id.* § 1001(a).

13. The term "like kind" refers to the nature or character of the property, and not to its grade or quality. Therefore, it is of no import that real estate is improved or unimproved since this condition relates solely to the quality of the property rather than its character. Treas. Reg. § 1.1031(a)-1(b) (1956).

14. INT. REV. CODE OF 1954, § 1031(c).

15. *See generally,* Cary, *Corporate Financing Through the Sale and Lease-Back of Property: Business, Tax, and Policy Considerations,* 62 HARV. L. REV. 1 (1948). The sale and leaseback transaction consists of a property owner selling the property with the buyer contemporaneously executing a lease of the property back to the original owner. The leaseback is often found in the sale agreement itself, and is a condition of the sale. If a bona fide lease is found, the taxpayer-lessee is permitted to deduct all of the rental payments under section 163 of the Code. INT. REV. CODE OF 1954, § 163. This would more than offset the loss of depreciation deductions, which the taxpayer is entitled to as owner of the property, because the lessee could deduct the total investment contained in the rental payments, including the land which may not be amortized. Treas. Reg. § 1.167(a)-2 (1956).

In addition to these tax motives, the sale and leaseback also has other sound business purposes. By selling the property and then leasing it back, a taxpayer may receive cash immediately, while spreading its costs over a period of time as rent. Restrictions found in bond indentures and loan agreements can be avoided, and the cash obtained by the taxpayer is often the full market value of the property, rather than the fraction which is usually realized through the use of a mortgage. For a discussion of the business purposes behind the utilization of the sale and leaseback, *see* Cary, *Current Problems in Sale, or Gift, and Lease-Back Transactions,* 29 TAXES 662 (1951); Cary, *Tax Aspects of the Sale and Lease-Back of Corporate Property,* N.Y.U. 7TH INST. ON FED. TAX 599 (1949); Mandell, *Tax Aspects of Sales and Leasebacks as Practical Devices for Transfer and Operation of Real Property,* N.Y.U. 18TH INST. ON FED. TAX 17 (1960).

16. 192 F.2d 155 (8th Cir. 1951), *cert. denied,* 342 U.S. 954 (1952).

ness property and, therefore, not a sale.[17] As the *Century Electric* court noted, the legislative purpose behind the nonrecognition provisions of section 1031 reflects Congress' concern with the administrative problems of computing a gain or loss when neither is readily measurable due to the nature of an exchange not involving money but rather like kind business property.[18] While in theory a taxpayer may have realized a loss or a gain, in fact the nature and extent of his or her interest would remain basically unchanged.

Eight years later, in *Jordan Marsh Co. v. Commissioner,*[19] while the Tax Court followed *Century Electric* and disallowed a loss deduction in a similar transaction,[20] the United States Court of Appeals for the Second Circuit reversed, holding that there had not been an exchange of business property, but rather a sale at the fair market value of the property followed by a separate leaseback.[21] Accordingly, the *Jordan Marsh* court allowed the deduction. Unlike *Century Electric,* the taxpayer in *Jordan Marsh* was found to have altered its economic situation in that it had " 'closed out a losing venture' " by selling its business property.[22] Therefore, the court reasoned, as the primary legislative purpose behind section 1031 was to avoid the recognition by a taxpayer of a loss or gain in a transaction where there had been a mere change in the *form* of ownership,[23] section 1031 should not apply in this situation as the taxpayer had suffered a *quantitative* change as well.[24]

Missouri Pacific Railroad v. United States[25] is the most recent decision dealing with the tax consequences of the sale and leaseback arrangement.[26] In *Missouri Pacific,* the United States Court of Claims recognized that although the long-term leaseback had been the quid pro quo for the sale of the property, this factor was not controlling as to the applicability of

17. 192 F.2d at 159–60.

18. *Id.* at 159.

19. 269 F.2d 453 (2d Cir. 1959).

20. 16 CCH Tax Ct. Mem. 1094 (1957), *not acquiesced in,* REV. RUL. 60–43, 1960–1 CUM. BULL. 687. The lease was for a term of 30 years and 3 days, with an option to renew for 30 more years if the lessee should erect new buildings. 269 F.2d at 454. Significantly, there was no option for the seller-lessee to repurchase the property.

21. 269 F.2d at 456.

22. *Id.* at 456, *quoting* Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st Cir. 1940).

23. 269 F.2d at 456.

24. *Id.*

25. 497 F.2d 1386 (Ct. Cl. 1974).

26. One of the four issues facing the *Missouri Pacific* court was the tax consequences of the sale of the taxpayer's St. Louis headquarters and office buildings with a simultaneous leaseback for a term of 29 years and 11 months, accompanied by a right to renew for four additional periods of 5 years each. *Id.* at 1387–88. The taxpayer also received an absolute option to reacquire the property after a period of 5 years. *Id.* at 1390. A claimed loss deduction on the sale was disallowed by the Commissioner, who viewed the disposition as an exchange of real estate for property of like kind within the meaning of section 1031(c). *Id.* at 1388.

section 1031.[27] Rather, where such reciprocity is present, in order to avoid the application of the nonrecognition provisions it must be shown:

> (1) that the seller has relinquished effective control of the property; (2) that the lease is for a total term of no more than thirty years, inclusive of optional renewal periods; (3) that the consideration, apart from the lease, for the transfer is fairly equivalent to the market value of the property transferred; and (4) that the rental payments under the lease are reasonable compensation for the use and occupancy of the desired premises.[28]

The court found that, on the facts, the first and second[29] requirements of the test had not been met, and therefore section 1031 applied.[30] *Jordan Marsh* was distinguished on the basis that the sale of the property in that case had been unconditional while in *Missouri Pacific* the contract of sale provided for certain repurchase options for the taxpayer.[31] The *Missouri Pacific* court reasoned that had the taxpayer in *Jordan Marsh* retained the right to repurchase the property in the near future at a reasonable price, then there would not have been a "closing of a losing venture"[32] but merely a suspension thereof, and thus no sale for tax purposes.[33]

As an alternative approach to the sale and leaseback issue, several courts have been willing to look through the mere form of the deed and treat the transaction as a mortgage if it is determined that the sale and leaseback arrangement was actually executed as security for a loan.[34] In such instances the original owner would then be deemed not to have relinquished ownership of the property, and therefore, the questions of whether a "sale" or "exchange" had occurred and whether section 1031 applies would never arise. In *Commissioner v. H.F. Neighbors Realty Co.*,[35] the Sixth Circuit expressed the general tenor of this approach in finding that a mortgage had resulted and stated:

> The more common criteria which indicate a borrowing and lending rather than a purchase and a sale, are inadequacy of consideration, provisions for redemption or reconveyance, continued possession

27. *Id.* at 1390–91.

28. *Id.* at 1391, *citing* 5 MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 28.28a (1969 rev.). It is significant that the *Missouri Pacific* court, confronted with a situation where a sale of property was conditioned upon its immediate leaseback, chose to ignore the general presumption in favor of the applicability of section 1002, and instead presumed the applicability of section 1031. The court offered no explanation for this presumption in favor of section 1031, but it is important to the extent that it makes a finding of the applicability of section 1031 easier.

29. *See* note 60 *infra.*

30. 497 F.2d at 1391.

31. *Id.* at 1393.

32. *Id.*

33. *Id.*

34. *See, e.g.*, Helvering v. F. & R. Lazarus & Co., 308 U.S. 252 (1939); Commissioner v. H.F. Neighbors Realty Co., 81 F.2d 173 (6th Cir. 1936).

35. 81 F.2d 173 (6th Cir. 1936). This case involved a transaction whereby land was given to a trustee in return for a 99-year leaseback and land trust certificates.

> and management of the property by the transferer, payment by him of the taxes and assessments, and his receipt and use of the rents and profits of the property.[36]

Confronted with these conflicting decisions as to agreements fundamentally similar in nature, the *Leslie* court began its analysis by emphasizing that the "exchange" prerequisite to the operation of section 1031 necessitated a transfer of property for property, in whole or in part, as distinguished from a transfer of property solely for cash.[37] In considering whether the seller of property in a sale and leaseback transaction had received in return any property in addition to cash — in which case the transaction might be considered an exchange with cash as boot — the *Leslie* court inquired as to whether the leaseback had a capital value of its own.[38] The court's determination that the leasehold did not have any capital value which could be considered a part of the consideration paid or exchanged[39] was premised upon evidence in the record[40] indicating that the fair market value of the property with improvements at the time of the sale was roughly equivalent to the sale price.[41] The court felt this determination was further buttressed by the fact that the annual net rental[42] was comparable to that of similar properties in the area.[43] The court noted that the fair value of both the sales price and rentals coupled with the lease provision that all condemnation proceeds would be paid to Prudential without deduction for the leasehold, all supported the finding that the leasehold had no capital value.[44] Since the leasehold was deemed to have no value, and the sole consideration paid for the property therefore could only be the $2.4 million,[45] the court concluded that there was a sale of the property and not an exchange within the meaning of section 1031.[46]

The *Leslie* court's particular mode of analysis of the exchange issue, in emphasizing the fact that the fair market value of the property equaled

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36. *Id.* at 175. The United States Supreme Court upheld the reasoning of *Neighbors* when a similar fact situation arose 3 years later in Helvering v. F. & R. Lazarus & Co., 308 U.S. 252 (1939). The *Lazarus* case involved the transfer of land coupled with a long-term leaseback and the issuance of trust certificates. The Court, in that case, found the transaction to be a loan and the transferor was permitted to continue to depreciate the property. *Id.* at 255.

37. 64 T.C. at 252. The Treasury regulations provide: "[T]o constitute an exchange, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only." Treas. Reg. § 1.1002-1(d) (1957).

38. 64 T.C. at 252; *cf.* Jordan Marsh Co. v. Commissioner, 269 F.2d 453, 456–57 (2d Cir. 1959).

39. 64 T.C. at 252.

40. This evidence was introduced by the Commissioner. *Id.* at 253.

41. *Id.* If the sale price of $2.4 million had been less than the fair market value of the improved property, an inference might have arisen that the difference represented the capital value of the leasehold. *See* note 50 *infra.*

42. *See* note 7 *supra.*

43. 64 T.C. at 253.

44. *Id.*

45. *Id.*

46. *Id.* at 255.

the purchase price, may have predetermined the result. An alternative approach the court might have taken would have been to assess the nature of the taxpayer's interest in the property prior and subsequent to the sale and leaseback instead of concentrating on fair market values. If it had appeared that the taxpayer's overall interest had not been significantly altered by the transaction, this would have indicated that an exchange of like kind property had occurred.[47]

Even accepting the *Leslie* court's fair market value approach, its determination that the leasehold had no capital value such as would constitute non-cash consideration appears problematical. It is difficult to reconcile the majority's statements that "it was only because of the leasehold that petitioner was willing to spend $3.187 million,"[48] and that "the leaseback arrangement was a necessary condition to the sale,"[49] with the ultimate finding that the leasehold had no instrinsic value of its own. The court seems to have disregarded the economic realities of the situation, despite the frequently invoked principle that the economic substance of a transaction should govern for tax purposes, rather than the form or appellation which the parties give it.[50]

Moreover, even accepting the *Leslie* court's view that the taxpayer had sustained a recognizable loss, the court's failure to discuss factors which previously had been considered important in ascertaining the existence of the requisite "exchange" seems to add further confusion to an already unsettled area of the law. The court failed to note the fact that the taxpayer's investment after the transaction was of a substantially similar nature, a factor important to the Second Circuit in *Jordan Marsh*.[51] Nor

47. *See* notes 16–18 and accompanying text *supra*.

48. 64 T.C. at 252.

49. *Id.*

50. *See* Helvering v. F. & R. Lazarus & Co., 308 U.S. 252, 255 (1939); George A. Roesel, 56 T.C. 14, 25–26 (1971). In the instant case the Commissioner contended that since the cost to the taxpayer exceeded the contract price, the difference would equal the capital value of the lease. 64 T.C. at 253. While the majority recognized that economic realities would seem to indicate that the excess of cost over contract price would not be a loss to the petitioner since it would be able to utilize the improvements as lessee, and therefore, willing to spend more than $2.4 million, the court nevertheless concluded that the leasehold had no capital value. *Id.* at 254. Rather, the difference between the $2.4 million received and the $3.187 million expended was found to be attributable to the cost of acquiring the land and making the improvements, not to the value of the leasehold. The court reasoned that in order for the difference of $787,414 to be the value of the lease, the fair market value of the property would have to be equal to $3.187 million, a fact which the evidence failed to support. *Id.*

Judge Wilbur, in his dissenting opinion, noted that since the contract between Prudential and the taxpayer provided that the sale price was to be the lesser of the actual costs of the land and improvements or $2.4 million, the taxpayer could not possibly make a profit. Accordingly, he concluded with regard to the capital value that "[t]he expenditure at issue here was clearly incurred for the leasehold interest of 50 years." *Id.* at 258 (Wilbur, J., dissenting). Moreover, all of the dissenting judges expressed the view that the taxpayer had not actually sustained a loss; the excess of the cost over the sales price in fact represented the value of the leasehold. *See id.* at 256 (Tannenwald, J., dissenting); *id.* at 257 (Quealy, J., dissenting); *id.* at 259 (Wilbur, J., dissenting).

51. *See* note 23 *supra*.

did the *Leslie* court discuss the fact that the lease was for a term of more than 30 years and that the taxpayer retained effective control of the property, factors which the *Missouri Pacific* court had deemed significant.[52]

As suggested earlier, the *Leslie* court could have approached the issue analytically by inquiring whether the nature of the taxpayer's financial interests were affected by the transaction, and finding an exchange if no significant change had occurred. This appears especially significant in *Leslie,* for it is not sufficiently apparent that the taxpayer's reported $787,414 loss from the transaction resulted in any significant alteration of its business operations.[53] Although the basic fact situations were distinguishable the *Leslie* court relied upon *Jordan Marsh* in holding that the present transaction was a sale rather than an exchange, since the selling price of the property was equivalent to its fair market value.[54] While the Second Circuit did emphasize in *Jordan Marsh* the fact that the leasehold had no independent value, that case may be distinguished since the taxpayer was selling property which it had held for a considerable period of time,[55] undertaking costs in excess of the fair market value, independently of the sale and leaseback transaction.[56] However, in the instant case, the taxpayer had not incurred the costs of acquiring the land and constructing the plant over a period of years in its business operation;[57] rather, the costs were assumed with a view to selling the property and leasing it back from Prudential. Thus this was not a case of "closing out a losing venture" as in *Jordan Marsh.*[58] It is submitted that for this reason, and the fact that the sale in the instant case was expressly conditioned upon an immediate long-term leaseback,[59] the Court of Claims would not have found the transaction involved in *Leslie* to be a sale. As the lease in the instant case was for a period of up to 50 years,[60] and the taxpayer had retained

52. *See* notes 60 & 61 and accompanying text *infra.*

53. The taxpayer owned the property and newly constructed plant which was to have been used in its manufacturing process prior to the sale to Prudential. Following the completed transaction, the taxpayer retained the complete use and occupancy of the property for a term potentially as long as 50 years. It is true that the taxpayer now had to pay an annual rental of over $190,000; however, it had also received the benefit of $2.4 million in cash which it needed due to the cost of constructing the plant, and which it had been unable to satisfactorily obtain by alternate means. 64 T.C. at 249-50.

54. *Id.* at 256, *citing* Jordan Marsh Co. v. Commissioner, 269 F.2d 453 (2d Cir. 1959).

55. The taxpayer had acquired the property in question in 1925, while the sale and leaseback occurred in 1944. 16 CCH Tax Ct. Mem. 1094, 1095 (1957).

56. *See* 64 T.C. at 255 (Tannenwald, J., dissenting).

57. *Id.* at 249-50.

58. *See id.* at 256 (Tannenwald, J., dissenting).

59. *See* notes 30-33 and accompanying text *supra.*

60. The *Missouri Pacific* requirement of the lease being for a term of 30 years or less was inferred from regulation section 1.1031(a)-1(c)(2) which provides for nonrecognition if "a taxpayer who is not a dealer in real estate . . . exchanges a leasehold of a fee with 30 years or more to run for real estate . . . ." Treas. Reg. § 1.1031(a)-1(c)(2) (1956). This regulation does not, however, answer the primary question as to whether the transaction was an "exchange" or not. Since the concept of a sale implies the transfer of complete ownership of an object, it would seem

effective control of the property,[61] the sale and leaseback arrangement involved therein fails the test as to recognition set forth in *Missouri Pacific*.[62]

Neither the parties, nor the majority in *Leslie* addressed themselves to the issue of whether the transaction was actually a financing arrangement rather than a sale.[63] However, previous cases have shown that if a repurchase option is contained in a sale and leaseback transaction, a court might properly find that the seller has retained an "equity" in the property and hold that the transaction creates a mortgage instead of a lease.[64] In light of its provisions for a repurchase offer by the taxpayer, as well as the taxpayer's possession, management, and obligation to pay all taxes, maintenance, and other charges on the property,[65] the agreement in the instant case appears to meet most of the criteria enumerated in *Neighbors* as indicating the creation of a mortgage.[66] The use of the sale and lease-

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that the relinquishment of effective control is a valid factor in determining whether a sale has actually occurred.

61. *See* note 41 *supra*. Repurchase options were considered by the *Missouri Pacific* court to amount to the retention of effective control over business property. 497 F.2d at 1393. In ascertaining whether the taxpayer in *Leslie* gave up control of the property in question, thus meeting the requirement in *Missouri Pacific*, it must be acknowledged that the taxpayer's repurchase option did not give it as much control as did the taxpayer's absolute right to repurchase after 5 years in *Missouri Pacific*. *Id.* The question then arises as to how much control can be retained by the seller of property before the transaction will not be deemed to be a sale. It is submitted that in resolving this problem as to retention of control there exists a line of sale and leaseback decisions, not concerning the application of section 1031, which proves helpful. In each of these cases, the courts, in determining whether a bona fide sale had occurred or only a sham to avoid taxes, noted that the absence of an option to repurchase indicated that the seller had given up effective control and a sale had actually taken place. *See* City Inv. Co. & Subsidiaries, 38 T.C. 1 (1962), *not acquiesced in*, 1963-1 CUM. BULL. 5; May Dep't Stores Co., 16 T.C. 547 (1951); Standard Envelope Mfg. Co., 15 T.C. 41 (1950).

Although the taxpayer had only a rejectable offer to repurchase, this did not mean that Prudential could refuse such an offer without any adverse consequences. The lease provided that if Prudential rejected a purchase offer, the lease would terminate. 64 T.C. at 257 n.2 (Wilbur, J., dissenting). Since there is some indication that Prudential considered itself more as a lender than as a landlord, the company may have been hesitant to reject any offer the taxpayer may have made. *Id.* at 258 n.4 (Wilbur, J., dissenting). It is not clear from the opinion whether the plant could have been easily rented to another company, or whether it was specifically suited to only the taxpayer's needs. However, if it would have been difficult for Prudential to sell or lease the premises to someone else, the option to purchase may have been absolute in effect, and thus the taxpayer would have retained effective control.

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

63. *See* 64 T.C. at 257 n.4 (Tannenwald, J., dissenting).

64. *See* Chicago Stoker, 14 T.C. 441 (1950); *see generally* Cohen & Meisel, *A Later Look at the Sale and Leaseback*, 5 ST. LOUIS U.L.J. 169, 186-90 (1958).

65. 64 T.C. at 250 n.3.

66. Although both the *Neighbors* and *Lazarus* cases involved the use of land trust certificates, this should not be controlling if the facts otherwise indicate a mortgage agreement. These land trust arrangements, like the "sale" by Leslie in the present case, transferred the legal title of the property. However, in the land trust transaction, the legal title vests in a trustee who manages the property, and the holder of the trust certificates may receive a share of the profits realized by the business operations of the property. *See* G.G. BOGERT & G.T. BOGERT, HANDBOOK OF THE LAW OF TRUSTS §§ 32, 47, 88 (5th ed. 1973).

back is recognized to be a modern alternative to the traditional bond and mortgage loan,[67] and if the *Neighbors* criteria are met, the economic realities should be acknowledged and the arrangement considered a loan for tax purposes. This analysis is especially applicable to the transaction in *Leslie,* not only because it meets the criteria in *Neighbors,* but also because the evidence indicates that the parties entered into the agreement solely to provide funds for the construction of the taxpayer's new facilities.[68] In light of the fact that the agreement with Prudential was entered into only after other financing possibilities had been unsuccessfully explored,[69] and that Prudential, in all probability, viewed itself as a lender rather than a landlord,[70] it appears that the Commissioner could have presented a convincing argument that the transaction at issue was in actuality a loan. Although the *Leslie* court might have concluded that section 1031 was inapplicable since the taxpayer had never really held the building for "productive use in trade or business"[71] before the sale to Prudential,[72] its refusal to find a section 1031 transaction based upon the view that there was no reciprocal transfer of non-cash property, may provide an incentive for companies in the future to sell a portion of their business property with the intent of leasing it back and taking a loss deduction, when ordinarily a mortgage loan would have been utilized. If the *Leslie* court is holding that in order for the nonrecognition provisions to be deemed inapplicable a taxpayer need only show that property was transferred and a subsequent lease entered into at respective fair market values,[73] then the taxpayer would realize the benefit of a loss deduction even though it would not have been available had a traditional mortgage been employed.[74] If the adjusted basis of such property is less than the fair market value, the taxpayer could use a standard mortgage to avoid any possible gain, and thus the taxpayer would win in either case.

The *Leslie* decision may also produce a type of forum-shopping since taxpayers who realize a loss in the sale and long-term leaseback situation may take the deduction and litigate the deficiency asserted by the Commissioner in the Tax Court rather than pay the tax, or where a gain is realized, pay the tax on the gain and then sue for a refund in the Court of

67. *See* Rohrlich, *Initial Capitalization and Financing of Corporations,* 13 VAND. L. REV. 197, 199 (1959).

68. *See* note 2 and accompanying text *supra.*

69. 64 T.C. at 249.

70. *See* note 61 *supra.*

71. INT. REV. CODE OF 1954, § 1031(a); *see* note 9 *supra.*

72. 64 T.C. at 253.

73. *See* notes 21-28 and accompanying text *supra.*

74. While the taxpayer can take a deduction under section 163 for the interest paid on a mortgage, *see* INT. REV. CODE OF 1954, § 163, this might not necessarily be as great as the loss deduction. The taxpayer would also have the advantage of taking the full loss deduction immediately, rather than having to wait until each interest payment is actually made.

Claims or a federal district court.[75] The possibility exists as long as the Court of Claims, following its recent decision in *Missouri Pacific,* applies the nonrecognition provisions of section 1031 in situations involving leases for over 30 years, while the Tax Court, following *Leslie,* continues to characterize a similar arrangement as a sale and allow the deduction.

At the time that *Jordan Marsh* was being appealed to the Second Circuit, it was suggested that if that case should be decided contrary to the position taken by the Eighth Circuit in *Century Electric* the Supreme Court would probably undertake review of the sale and leaseback problem.[76] The Supreme Court has yet to decide this conflict, but its definitive opinion, or action by another governmental branch, is needed to bring order to this confused and unsettled area of the law.

Robert Long

LABOR LAW — ANTITRUST REMEDIES HELD APPLICABLE FOR VIOLATIONS OF SECTION 8(e) OF THE NLRA WHICH PROHIBITS "HOT CARGO" AGREEMENTS WHERE THE AGREEMENT VIOLATING SECTION 8(e) ALSO RESTRAINS OR MONOPOLIZES TRADE — ABSENT A COLLECTIVE BARGAINING RELATIONSHIP, THE CONSTRUCTION INDUSTRY PROVISO TO SECTION 8(e) HELD INAPPLICABLE.

Connell Construction Co. v. Plumbers Local 100 (U.S. 1975)

Local 100 of the United Association of Journeymen and Apprentices of the Plumbing and Pipefitting Industry (Union), the bargaining representative for plumbing and mechanical tradesmen in the Dallas area, had a collective bargaining agreement with an association of mechanical contractors.[1] In late 1970, the Union approached Connell Construction Company (Company), a general contractor whose employees the Union neither represented nor wished to represent, and requested that the Company sign an agreement promising not to subcontract any work falling within the normal trade jurisdiction of the Union to a firm which did not have a

75. A taxpayer may contest a notice of deficiency by petitioning the Tax Court for a redetermination of the deficiency. During this time, no tax is to be collected. INT. REV. CODE OF 1954, § 6213(a). Alternatively, a taxpayer may pay the tax, then sue for a refund in a federal district court or in the Court of Claims as a "claim against the United States founded . . . upon . . . any Act of Congress." 28 U.S.C. § 1491 (1970).

76. Cohen & Meisel, *supra* note 64, at 191.

1. Connell Constr. Co. v. Plumbers Local 100, 421 U.S. 616, 619 (1975). The agreement contained a "most favored nation" clause, in which the Union agreed that if it granted a more favorable contract to any firm which was not a member of the association, it would extend the same terms to all association members. *Id.*

current contract with the Union.[2] Upon the Company's refusal to sign the agreement, the Union commenced picketing at one of the Company's major construction sites, causing approximately 150 men to walk off the job.[3] The Company brought suit in state court seeking injunctive relief under Texas antitrust laws.[4] After the Union removed the case to federal court,[5] the Company signed the agreement under protest.[6] The Company amended its complaint to include allegations that the agreement violated sections 1 and 2 of the Sherman Act,[7] and was therefore invalid.[8]

The district court held the agreement exempt from the federal antitrust laws because the construction industry proviso of section 8(e) of the

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2. *Id.* at 619–20.

3. *Id.* at 620.

4. *Id.; see* TEX. BUS. & COM. CODE §§ 15.01–.04 (1968).

5. The case was removed from state court to United States district court pursuant to 28 U.S.C. § 1441 (1970).

6. 421 U.S. at 620.

7. 15 U.S.C. §§ 1, 2 (1970). Section 1 of the Sherman Act prohibits contracts, combinations, or conspiracies in restraint of trade. *Id.* § 1. Although the term restraint of trade was not expressly defined by Congress in the Act, the Supreme Court, interpreting the section in light of the background of the common law, has determined that only unreasonable restraints of trade were prohibited. Standard Oil Co. v. United States, 221 U.S. 1, 59–60 (1911). Reasonableness was to be determined from the facts of each case. *Id.* Relying upon this statutory interpretation, the Court has stated that restraints of trade prohibited by the Sherman Act

> only embraced acts or contracts or agreements or combinations which operated to the prejudice of the public interests by unduly restricting competition or unduly obstructing the due course of trade or which either because of their inherent nature or effect or because of the evident purpose of the acts, etc., injuriously restrained trade . . . .

United States v. American Tobacco Co., 221 U.S. 106, 179 (1911).

Section 2 of the Act outlaws monopolization, attempts to monopolize, and combinations and conspiracies to monopolize. 15 U.S.C. § 2 (1970). The offense of monopolization is made out by proving two elements: 1) monopoly power; and 2) a general intent to monopolize. *See* United States v. Grinnell Corp., 384 U.S. 563 (1966); United States v. Aluminum Co. of America, 148 F.2d 416 (2d Cir. 1945). *See generally* Note, *Monopolization Under Section 2 of the Sherman Act,* 22 S. CAR. L. REV. 345, 349–60 (1970). Monopoly power has been defined as "the power to control prices or exclude competition." United States v. E.I. duPont de Nemours & Co., 351 U.S. 377, 391 (1956). The intent element of a monopolization violation is fulfilled by a showing of "the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident." United States v. Grinnell Corp., *supra* at 571.

The offense of attempting to monopolize requires proof of two major elements: 1) the specific intent to monopolize, and 2) a dangerous probability that monopolization will result from the defendant's actions. Swift & Co. v. United States, 196 U.S. 375, 396 (1905). The problems with this definition are twofold. First, specific intent to monopolize may be inferred from the absence of a normal business purpose or predominant business motivation. *See* Times-Picayune Publishing Co. v. United States, 345 U.S. 594, 626 (1953); United States v. Columbia Steel Corp., 334 U.S. 495, 533 (1948). Second, more than half of the opinions on this subject in the lower federal courts ignore the dangerous probability requirement, and the Ninth Circuit has gone as far as to expressly reject it. Lessig v. Tidewater Oil Co., 327 F.2d 459, 474 (9th Cir.), *cert. denied,* 377 U.S. 993 (1964). *See* Hawk, *Attempts to Monopolize — Specific Intent as Antitrust's Ghost in the Machine,* 58 CORNELL L. REV. 1121, 1135 & n.73 (1973); *see generally* AMERICAN BAR ASSOCIATION, ANTITRUST LAW DEVELOPMENTS 1–60 (H. Appelbaum ed. 1975).

8. 421 U.S. at 620–21.

National Labor Relations Act (NLRA)[9] specifically permitted the agreement.[10] The Fifth Circuit affirmed upon the ground that the Union's goal of organizing all the employees of mechanical subcontractors was legitimate and, therefore, exempt from the antitrust laws.[11] The Supreme Court reversed in part,[12] *holding* that the construction industry proviso to section 8(e) did not specifically permit the agreement since no collective bargaining relationship existed between the Union and the Company and that the agreement between the Union and the Company was not immune from federal antitrust sanctions. *Connell Construction Co. v. Plumbers Local 100,* 421 U.S. 616 (1975).

Organized labor's immunity from the Sherman Act's prohibitions against specific anticompetitive practices was derived from sections 6[13] and 20[14] of the Clayton Act and the Norris-LaGuardia Act.[15] In *United*

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9. 29 U.S.C. § 158(e) (1970). Section 8(e) provides in pertinent part:

> It shall be an unfair labor practice for any labor organization and any employer to enter into any contract or agreement, express or implied, whereby such employer ceases or refrains or agrees to cease or refrain from handling, using, selling, transporting or otherwise dealing in any of the products of any other employer, or to cease doing business with any other person, and any contract or agreement entered into heretofore or hereafter containing such an agreement shall be to such extent unenforcible and void: *Provided,* That nothing in this subsection (e) shall apply to an agreement between a labor organization and an employer in the construction industry relating to the contracting or subcontracting of work to be done at the site of the construction, alteration, painting, or repair of a building, structure, or other work . . . .

Id.

10. Connell Constr. Co. v. Plumbers Local 100, 78 L.R.R.M. 3012 (N.D. Tex. 1971).

11. Connell Constr. Co. v. Plumbers Local 100, 483 F.2d 1154 (5th Cir. 1973). The Fifth Circuit did not pass upon the district court's finding that the agreement was specifically permitted by the proviso to section 8(e). *See* note 10 and accompanying text *supra.* The circuit court concluded that the National Labor Relations Board was the appropriate forum for the initial determination of whether the Union had violated section 8(e). 483 F.2d at 1171–75.

12. The Supreme Court affirmed the decision of the Fifth Circuit that Texas antitrust law was preempted by federal labor law. 421 U.S. at 621, 635–37. The Court relied upon a number of cases which have held that federal labor law preempts state remedies which interfere with specific provisions of the NLRA. *See id.* at 635, *citing* Association of St. Employees v. Lockridge, 403 U.S. 274 (1971); Teamsters Local 20 v. Morton, 377 U.S. 252 (1964), and Teamsters Local 24 v. Oliver, 358 U.S. 283 (1959).

The Supreme Court remanded the case to the lower court in order to determine whether the agreement did, in fact, violate the Sherman Act. 421 U.S. at 637. On remand, the district court will initially determine whether the Union was acting primarily to benefit its members' wages and working conditions in securing the agreement. *See* notes 18–20 and accompanying text *infra.* If not, the court will determine whether the agreement violates sections 1 and 2 of the Sherman Act. For discussion of what conduct violates the Sherman Act, *see* note 7 *supra.*

13. 15 U.S.C. § 17 (1970).

14. 29 U.S.C. § 52 (1970).

15. *Id.* §§ 101–15. The activities of a labor organization which were exempted by the Norris-LaGuardia Act from injunctions for alleged antitrust violations were listed in section 4 of that Act. *Id.* § 104.

Prior to the enactment of the Clayton Act in 1914, union activities were subject to the prohibitions of the Sherman Act. Loewe v. Lawlor, 208 U.S. 274 (1908). The Clayton Act failed to free unions from the sanctions of the Sherman Act because of the Supreme Court's narrow interpretation of the Act. *See* Coronado Coal Co. v.

States v. Hutcheson,[16] the Supreme Court construed the Clayton Act and the Norris-LaGuardia Act as exempting organized labor from classification as a combination in restraint of trade under the Sherman Act provided the union acted in its own self-interest and did not combine with non-labor groups. For two decades following *Hutcheson,* the Supreme Court's view of antitrust immunity for union activities remained unchanged.[17]

During the 1960's, the Court, recognizing that in collective bargaining a union combined with non-labor groups to further the union's self-interest, placed emphasis upon the union's purpose in entering into the combination.[18] The Court fashioned a non-statutory exemption from the antitrust

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UMW, 268 U.S. 295 (1925); Duplex Printing Co. v. Deering, 254 U.S. 443 (1921). In *Duplex Printing,* the Court ruled that the Clayton Act did not exempt unions from the Sherman Act when secondary union activities were involved because the definition of a labor dispute in section 20 of the Clayton Act was limited to disputes between an employer and his employees. 254 U.S. at 470–71. In *Coronado Coal,* the Supreme Court held that a primary dispute between an employer and his employees would be subject to the antitrust laws if it were shown that the union had the unlawful purpose of obstructing the flow of the employer's goods or services in commerce, and not merely that any such obstruction was an indirect by-product of a dispute involving legitimate union objectives. 268 U.S. at 310.

Section 13(c) of the Norris-LaGuardia Act superseded *Duplex Printing* by broadly defining a labor dispute to include situations where the parties were not situated in an employer-employee relationship. 29 U.S.C. § 113(c) (1970).

16. 312 U.S. 219, 232 (1941). The Court reasoned that the Clayton and Norris-LaGuardia Acts had not merely given organized labor immunity from injunctions, rather Congress had also intended to grant a broad exemption from any liability under the Sherman Act when the union acted in its own interest without combining with non-labor groups. *Id.* at 235. The Court further asserted that the exemption would not be lost even if the union's purpose was to restrain trade, provided the other requirements were met. *Id.* at 232.

17. In Allen Bradley Co. v. Local 3, IBEW, 325 U.S. 797 (1945), the Court affirmed the *Hutcheson* rationale. Through collective bargaining agreements with electrical contractors and manufacturers in New York City, the union had succeeded in having the contractors agree to purchase electrical equipment only from manufacturers having closed shop agreements with the union, and the manufacturers agreed to sell electrical equipment only to contractors having similar agreements with the union. *Id.* at 799. These agreements had the effect of preventing outside contractors and manufacturers from participating in the electrical contruction trade in New York City because the union's jurisdiction was limited to that city. *Id.* at 800. Due to the combination with non-labor groups, the Court was free to inquire into the purpose of the union's actions. The Court determined that the purpose was to aid the non-labor groups in creating a business monopoly and in controlling the marketing of goods and services. *Id.* at 809. Therefore, the union was held to have lost its exemption from the antitrust laws. *Id.*

18. American Fed'n of Musicians v. Carroll, 391 U.S. 99 (1968); Meat Cutters Local 189 v. Jewel Tea Co., 381 U.S. 676 (1965); UMW v. Pennington, 381 U.S. 657 (1965). The antitrust exemption was lost by the union in *Pennington* because the Court believed that the dominant objective of the union's agreement to demand the same wage scale of all coal operators, not merely those in the multi-employer bargaining unit with which the agreement was signed, was to force small operators out of business and not to obtain higher wages for the union's members. *Id.* at 664–65. In *Jewel Tea,* the Court said that the restrictions in the collective bargaining agreement, concerning the hours during which fresh meat could be sold, did not violate the Sherman Act because the union's primary purpose was to limit the number of hours that the union's members would be required to work. 381 U.S. at 691. In *Carroll,* the Court held that union regulations which fixed prices for certain musical

laws whereby the combination would be deemed exempt if the union's primary purpose was to directly benefit its members' wages or working conditions.[19] If some other purpose was found to be primary, and the combination had the effect of restraining trade in a significant way, the union would lose the antitrust exemption.[20]

The *Connell* Court appears to have implicitly recognized a third antitrust exemption for labor in situations where union conduct directly restrained trade, but was expressly allowed by the NLRA.[21] Consequently, the Court had to consider whether the construction industry proviso of section 8(e)[22] specifically permitted the agreement between the Company and the Union. As originally enacted,[23] the NLRA did not restrict secondary activity[24] by labor unions.[25] The initial attempt to regulate secondary activity was contained in section 8(b)(4) of the NLRA[26] which classified certain enumerated secondary activities as unfair labor practices. Specifically, section 8(b)(4) was aimed at union conduct intended to induce strikes or concerted work stoppages by employees in the course of their employment in order to force one employer or other person to cease doing business with another employer.[27] In an attempt to avoid the section 8(b)(4) prohibitions upon concerted activities, unions sought "hot cargo" contracts — direct agreements with employers having the same secondary effect.[28] In *Carpenters Local 1976 v. NLRB (Sand Door)*,[29] the Supreme

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engagements did not violate the antitrust laws since, in the entertainment industry, such limitations were the only means available to determine a union wage scale. 391 U.S. at 109.

19. Meat Cutters Local 189 v. Jewel Tea Co., 381 U.S. 676, 690 n.5 (1965).

20. UMW v. Pennington, 381 U.S. 657, 664–66 (1965).

21. Mr. Justice Stewart's dissent gleans this recognition from the Court's treatment of the section 8(e) issue. *See* 421 U.S. 616, 648 n.8 (1975) (Stewart, J., dissenting).

22. 29 U.S.C. § 158(e) (1970). For the pertinent text of section 8(e) of the NLRA, *see* note 9 *supra*.

23. Act of July 5, 1935, 49 Stat. 449 (1935).

24. Secondary activity is union activity which is used to bring pressure upon one essentially neutral employer to exact some concession from another employer with whom the union has a dispute. *See* W. OBERER & K. HANSLOWE, LABOR LAW: COLLECTIVE BARGAINING IN A FREE SOCIETY 377 (1972).

25. The Congressional decision in 1935 not to include sanctions against labor organizations for secondary activities might possibly be attributed to a general desire at the time to strengthen the economic power of unions in order to hasten recovery from the Great Depression. *See* AMERICAN BAR ASSOCIATION, THE DEVELOPING LABOR LAW 25–26 (C. Morris ed. 1971).

26. 29 U.S.C. § 158(b)(4) (1970).

27. *See* AMERICAN BAR ASSOCIATION, *supra* note 25, at 608.

28. *See* SENATE COMM. ON LABOR AND PUBLIC WELFARE, LABOR-MANAGEMENT REPORTING AND DISCLOSURE ACT OF 1959, S. REP. No. 187, 86th Cong., 1st Sess. 79 (1959) [hereinafter cited as REPORT ON L-MRDA]. In a hot cargo agreement, an employer agrees that his employees will not handle the products or materials of another employer, and that he himself will not deal with the other employer whom the union considers unfair to organized labor. *See* SENATE SELECT COMM. ON IMPROPER ACTIVITIES IN THE LABOR-MANAGEMENT FIELD, S. REP. No. 1139, 86th Cong., 2d Sess. 3 (1960).

29. 357 U.S. 93 (1958).

Court upheld the validity of hot cargo agreements so long as they were voluntarily observed.[30]

Congress, apparently wishing to close what it perceived to be a major loophole in the section 8(b)(4) ban against secondary activity,[31] enacted section 8(e), prohibiting hot cargo agreements in all but a few instances.[32] Excepted from the section 8(e) proscriptions were hot cargo agreements in the construction industry[33] which related solely to the contracting or subcontracting of work at the construction site.[34] The most difficult problem which the National Labor Relations Board (Board) and the federal courts have had to resolve concerning the construction industry proviso has been defining the scope of the jobsite limitation.[35] The Board has required that, in order for an agreement to be permitted under the proviso, it must only affect work to be done at a construction site and, additionally, that the work covered by the agreement must be of a kind which was normally done only at a construction site.[36] However, neither the Board nor the federal courts have required that the agreement list a specific jobsite, even absent

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30. *Id.* at 105–08. The *Sand Door* Court held that a strike or other concerted pressure, as defined in section 8(b)(4), to enforce a hot cargo agreement violated section 8(b)(4)(A) (presently section 8(b)(4)(B)). However, the Court noted that no such violation occurred if the agreement was voluntarily observed. *Id.*

31. *See* REPORT ON L-MRDA, *supra* note 28, at 80.

32. For the relevant text of section 8(e), *see* note 9 *supra.*

33. *See* COMM. OF CONFERENCE, REPORT ON LABOR-MANAGEMENT REPORTING AND DISCLOSURE ACT OF 1959, H.R. REP. No. 1147, 86th Cong., 1st Sess. 39 (1959) [hereinafter cited as REPORT ON 1959 ACT]. There is virtually no evidence in the legislative history as to the reason for including the construction industry proviso in section 8(e). The Senate conferees succeeded in including the proviso in the House bill which had banned all hot cargo agreements. *Id.* The only reason given by the Senate conferees for the proviso's inclusion was "to avoid serious damage to the pattern of collective bargaining" in the construction industry. 105 CONG. REC. 17327 (1959) (remarks of Senator John F. Kennedy); *id.* at 18134 (remarks of Representative Thomson).

34. REPORT ON 1959 ACT, *supra* note 33, at 39. The committee report makes clear that the construction industry proviso did not overrule the *Sand Door* case; strikes to enforce a hot cargo clause valid under the proviso remained an unfair labor practice under section 8(b)(4)(B). *Id.* The report also states that the proviso did not overrule the Supreme Court decision in NLRB v. Denver Bldg. Trades Council, 341 U.S. 675 (1951). REPORT ON 1959 ACT, *supra* note 33, at 39. In *Denver Building Trades,* the Court held that a strike to force a nonunion subcontractor off a construction site was secondary activity and violated section 8(b)(4). 341 U.S. at 689. However, the Court indicated that in the situation where no contract had been signed between the general and subcontractor, a strike against the general contractor to make the project all union would be primary and hence, not violative of section 8(b)(4). *Id.* at 688.

35. *See* AMERICAN BAR ASSOCIATION, *supra* note 25, at 671–74; Comment, *"Hot Cargo" Clauses in Construction Industry Labor Contracts,* 37 FORDHAM L. REV. 99, 102 (1968).

36. Operating Eng'rs Local 12, 204 N.L.R.B. 742 (1973), *modified,* 511 F.2d 848 (9th Cir. 1975); Ohio Valley Carpenters Dist. Council, 136 N.L.R.B. 977 (1962). For example, the mixing of concrete is work which is not limited to a construction site, and therefore, a subcontracting agreement relating to concrete mixing violates section 8(e). Teamsters Local 294 (Island Dock Lumber, Inc.), 145 N.L.R.B. 484 (1963), *enforced,* 342 F.2d 18 (2d Cir. 1965).

a collective bargaining relationship between the parties, as long as the work subject to the agreement met the construction site requirement.[37]

Confronted with the preceding historical development of both labor and antitrust law, the Supreme Court began its analysis in *Connell* by scrutinizing the Union's assertion that the agreement was exempt from the operation of federal antitrust laws. The Court, finding the statutory exemption unavailable,[38] inquired whether the agreement fell within the nonstatutory exemption allowing agreements whose anticompetitive effect among employers is due to contractual provisions concerning employees' wages and working conditions.[39] The Court concluded that the Union could not avail itself of the nonstatutory exemption because the potential restraint upon competition caused by the agreement did not result from an attempt by the Union to benefit its members in wages and working conditions, but rather from the Union's goal of organizing all the subcontractors in the area.[40]

The second issue faced by the *Connell* Court was the Union's contention that the subcontracting agreement[41] was exempt from the operation of the antitrust laws because it was explicitly allowed by the construction industry proviso to section 8(e) of the NLRA.[42] The Court stated that although the agreement fit within the literal language of the proviso, the substance of the transaction was the paramount concern.[43] Finding no

37. *See* Suburban Tile Center, Inc. v. Rockford Bldg. Trades Council, 354 F.2d 1 (7th Cir.), *cert. denied,* 384 U.S. 960 (1966); Construction Laborers Local 383 v. NLRB, 323 F.2d 422 (9th Cir. 1963); Papazian v. Los Angeles Bldg. Trades Council, 83 L.R.R.M. 2710 (C.D. Cal. 1973); Los Angeles Bldg. Trades Council (Fowler-Kenworthy Elec. Co.), 151 N.L.R.B. 770 (1965); Los Angeles Bldg. Trades Council (Couch Elec. Co.), 151 N.L.R.B. 413 (1965). Not until the Fifth Circuit's consideration of *Connell* has the issue arisen of whether a collective bargaining relationship was required. 483 F.2d at 1173–74.

38. 421 U.S. at 622–23. The statutory exemption was derived from the Clayton and Norris-LaGuardia Acts and the Hutcheson case. *Id.* It was unavailable to the Union in *Connell* because the combination was with the Company, which was a non-labor group. *Id.; see* notes 15 & 16 and accompanying text *supra.*

39. 421 U.S. at 622–23. The nonstatutory exemption to the antitrust laws is available if the union acts with the primary purpose of improving the wages or working conditions of its members. *See* notes 18–19 and accompanying text *supra.*

40. 421 U.S. at 623–26. The Court conceded the legality of this goal, but refused to allow direct restraints of trade as a means of attaining the goal. *Id.* at 625. In so holding, the Court rejected the holding of the Fifth Circuit in *Connell,* that the Union's goal must have been to restrain trade in order to find an antitrust violation. 483 F.2d 1154, 1169–71. The Court found that the subcontracting agreement, combined with the "most favored nation" agreement with the association of mechanical subcontractors (*see* notes 1 & 2 and accompanying text *supra*), could exclude non-union subcontractors from competition in the Dallas area, even if their competitive advantages resulted from efficient operations and not substandard wages and working conditions. 421 U.S. at 623–24.

41. *See* notes 1 & 2 and accompanying text *supra.*

42. 421 U.S. at 626. The Supreme Court rejected the Fifth Circuit's holding that the Board had exclusive jurisdiction to decide whether the Union had violated section 8(e). *Id.; see* note 11 *supra.* The Supreme Court stated that the federal courts may decide labor law questions which emerge as collateral issues in suits brought under independent federal remedies, including the antitrust laws. 421 U.S. at 626. *See generally* Meat Cutters Local 189 v. Jewel Tea Co., 381 U.S. 676, 684–88 (1965).

43. 421 U.S. at 628.

express rationale for the inclusion of the proviso in section 8(e), the *Connell* Court inferred that Congress had intended that the proviso allow agreements relating solely to the jobsite in order to avoid the general disruption which picketing causes in the completion of a construction project.[44] The Court determined further that the congressional objective in enacting section 8(e) was to limit "top-down" organizational campaigns by unions.[45] In order to effectuate this broad congressional objective, the Court determined that the construction industry proviso must be read in a limited context — to alleviate the problems which can occur when union and nonunion personnel work together on one construction project.[46] The Court reasoned that this limited purpose could be served, while at the same time effectuating the overall purpose of section 8(e), by limiting the availability of subcontracting agreements to parties in a collective bargaining relationship, since the union would then be acting for the employees of the contractor and could be presumed to be protecting its members from working alongside non-union men.[47]

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44. *Id.* at 628–30. The Court referred to the problems encountered in attempting to picket only one subcontractor on a jobsite as one reason for the inclusion of the proviso to section 8(e). *Id.* at 629–30. In attempting to picket only one subcontractor, an entire construction site was often closed down as other workers refused to cross the striking union's picket line. 421 U.S. at 630 n.9, *citing* 105 CONG. REC. 17881 (1959) (remarks of Senator Morse); *id.* at 15541 (memorandum by Representatives Thomson and Udall); *id.* at 15551–52 (memorandum by Senator Elliott); *id.* at 15852 (remarks of Representative Goodell), *and id.* at 20004–05 (remarks of Representative Kearns).

45. 421 U.S. at 632. While the specific objective of Congress in enacting section 8(e) was to prohibit hot cargo agreements in most industries, the section can be viewed as part of Congress' overall objective of limiting top-down organizational campaigns which are situations where a union boycotts an employer until his employees join the union. Section 7 of the NLRA gives employees the right to join a union, or to refrain from joining one. 29 U.S.C. § 157 (1970). The subcontracting agreement in *Connell* might have forced the non-association subcontractors to violate their employees' section 7 right to refrain from union membership because the employer would have been faced with the choice of either remaining nonunion and being unable to compete, or coercing his employees into joining the Union. *See id.* § 158(a)(1). The Court determined that Congress could not have intended such a result under the section 8(e) proviso. 421 U.S. at 632–33.

Further, Congress manifested its disapproval of top-down organizing in 1959 with the passage of section 8(b)(7), 29 U.S.C. § 158(b)(7) (1970) (originally enacted as Act of Sept. 14, 1959, Pub. L. No. 86–257, § 704(c), 73 Stat. 519. This section allows a union to picket an employer whose employees are not represented by a union, but the union must file a petition with the Board for a representative election within a maximum of 30 days after the start of picketing. 29 U.S.C. § 158(b)(7)(C) (1970). One of the major purposes for the requirement of filing an election petition is to prevent the union's picketing from forcing the employer to coerce his employees to join the union without an election, which would clearly constitute an instance of top-down organizing. *See* Cox, *The Landrum-Griffin Amendments to the National Labor Relations Act*, 44 MINN. L. REV. 257, 262–63 (1960).

46. 421 U.S. at 630, *citing* Drivers Local 695 v. NLRB, 361 F.2d 547, 553 (D.C. Cir. 1966).

47. 421 U.S. at 633. It should be noted that this was merely a presumption since the union may still have an overall organizational purpose, even if there is a collective bargaining relationship.

The Court also determined that the labor law remedies for violation of section 8(e) were not intended by Congress to be exclusive. The Court reasoned that the

The Court's analysis of the Union's claim that the agreement was beyond the reach of federal antitrust law was consistent with its past treatment of the antitrust exemption for organized labor.[48] Because the Court found the agreement not immune from the antitrust laws, its decision that the agreement was not permitted by the construction industry proviso was extremely significant since the agreement, though potentially violative of sections 1 and 2 of the Sherman Act, could have been expressly made legal by a finding that it fell within the ambit of the section 8(e) proviso.[49]

The Supreme Court's treatment of the proviso was a significant departure from the approach taken by the Board and the lower federal courts. The Board's analysis had been primarily concerned with the statutory language — whether the work which was the subject of an agreement was normally done only at the construction site.[50] The *Connell* Court chose instead to place primary analytical emphasis upon whether the agreement would frustrate Congress' purpose for enacting section 8(e) — the elimination of top-down organizational campaigns.[51]

Despite the Court's laudable approach of examining congressional intent rather than merely the statutory language, analytical problems remain. First, if the congressional objective in enacting section 8(e) was to eliminate top-down organizational campaigns, it is difficult to understand why the Court placed reliance upon the collective bargaining relationship as a requirement for a valid subcontracting agreement under the proviso.[52] If, as the Court indicated, Congress' major concern was the elimination of top-down organizing, which transcends the limited exemption offered to the construction industry in the proviso, a more appropriate method of

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antitrust remedies would also be available because these remedies were consistent with the remedial scheme of the NLRA. *Id.* at 633–35. For a further discussion of the labor law remedies available for a violation of section 8(e), *see* note 56 *infra.*

48. 421 U.S. at 621–23. The Court followed its prior decisions in Meat Cutters Local 189 v. Jewel Tea Co., 381 U.S. 676 (1965), and UMW v. Pennington, 381 U.S. 657 (1965). On the facts of the instant case, the Court attempted to determine whether the Union's procurement of the subcontracting agreement was designed primarily to enhance the wages and working conditions of its members. *See* note 18 and accompanying text *supra.* The Court found that the agreement was primarily an organizational device and hence did not meet the standard for the nonstatutory exemption as delineated in previous cases. 421 U.S. at 623.

49. This is precisely what the district court held in *Connell.* 78 L.R.R.M. at 3014. It should be noted that the Supreme Court did not reverse the district court's holding upon the ground that the section 8(e) proviso could not validate an agreement which was invalid under the antitrust laws. 421 U.S. at 626–33. Rather, the Supreme Court reversed because it determined that the conditions of the section 8(e) proviso had not been met. *Id.*

50. *See* notes 35–37 and accompanying text *supra.*

51. *See* 421 U.S. at 632–33; note 45 *supra.*

52. 421 U.S. at 633. The presence of a collective bargaining relationship should not be determinative of whether the union has an organizational motive. *See* note 47 *supra.* The presumption which the collective bargaining relationship raises that the union was acting to protect its members from having to work alongside nonunion men seems reasonable, since it attempts to add certainty to the question of when such an agreement will be deemed valid under the proviso. However, it does not necessarily follow that in all cases the union will have this legitimate objective. *Id.*

implementing congressional intent would be to require a Board finding that a hot cargo agreement was intended as an organizational weapon. Should there be such a Board finding, the agreement would be held to violate section 8(e), notwithstanding the fact that the agreement literally complied with the construction industry proviso.[53]

The second problem with the Court's analysis is that arguably, the Court misread Congressional intent, not regarding the purpose of section 8(e), but as to the scope of the exemption provided by the proviso to construction unions from the prohibitions of section 8(e). As the Court admitted, there is scant direct evidence from which the congressional purpose regarding the proviso may be ascertained.[54] However, it does not seem implausable that Congress wished to exempt construction trade unions from the limitations upon top-down organizing as well as from the general ban upon hot cargo agreements contained in section 8(e).[55]

The *Connell* Court's holding that the labor laws were not meant to be the exclusive remedy for violations of section 8(e) has some merit.[56] The decision by Congress in 1947 that labor law be the exclusive remedy for violations of section 8(b)(4)[57] does not mandate that violations of Section 8(e) be remedied only by federal labor laws. The type of activities regulated under sections 8(b)(4) and 8(e) are distinguishable upon the grounds

53. While this approach does not possess the advantage of providing certainty, because it would necessitate a determination of union motive in every case, it is submitted that a finding of organizational motive would seem to better effectuate the avoidance of top-down organizing.

54. 421 U.S. at 628–29; *see* note 33 *supra.*

55. It is arguable that an examination of prior Board decisions indicates its belief that the proviso exempted the construction trade unions from the section 8(e) policy against top-down organizational campaigns. This observation may be inferred by the Board's failure to require a collective bargaining relationship, upon which the *Connell* Court placed such great weight. *See* Los Angeles Bldg. Trades Council (Fowler-Kenworthy Elec. Co.), 151 N.L.R.B. 770 (1965). *See also* 483 F.2d at 1158, where the Fifth Circuit referred to a case, involving the Union with facts similar to those in *Connell,* in which the Regional Director and General Counsel of the Board refused to issue a complaint against the Union for section 8(e) violations.

56. The issue of whether antitrust remedies were available for violations of section 8(e) was the basis of Mr. Justice Stewart's dissent in *Connell.* 421 U.S. at 639–55 (Stewart, J., dissenting). It should be noted that Justice Powell's majority opinion failed to enunciate a rationale for the non-exclusivity of the remedies of the federal labor laws. *See id.* at 633–35.

An examination of the legislative histories of the Taft-Hartley Act of 1947, and the Landrum-Griffin Act of 1959 suggests that Congress rejected attempts to impose antitrust sanctions for violations of specific provisions of the NLRA. *See* 421 U.S. at 640–54 (Stewart, J., dissenting). Instead, Congress chose to impose labor law penalties upon unions for violations of the secondary activity provisions of the Act. *Id.* at 645–50 (Stewart, J., dissenting).

Federal labor law provides varied remedies for violations of section 8(e). Section 303 of the Labor Management Relations Act (LMRA) allows any person injured by a union's attempt to enter into a hot cargo clause prohibited by section 8(e) to sue in a federal district court and recover his actual damages. 29 U.S.C. § 187 (1970). Section 10(1) of the NLRA provides for speedy injunctive relief, at the initiative of an officer of the Board, for violations of section 8(e). *Id.* § 160(1).

57. *See* 421 U.S. at 640–46 (Stewart, J., dissenting).

that section 8(b)(4) deals with unilateral secondary activity by unions[58] while section 8(e) concerns combinations between labor and non-labor groups.[59] The Court's distinction between sections 8(b)(4) and 8(e) arguably was valid because of the greater potential for harm to commerce when a union combines with a non-labor group.[60]

However, the Court's analysis is open to dispute since Congress' rejection in 1947 of antitrust remedies for section 8(b)(4) infractions and its failure to expressly repeal the antitrust exemption for labor unions can be read as demonstrating its preference for labor as opposed to antitrust law remedies where organized labor is concerned.[61] Further, the express choice by Congress not to abrogate legislative and judicial antitrust exemptions in either 1947 or 1959, leads to the conclusion that it intended the exemptions to continue, at least for those activities by organized labor which Congress expressly regulated.[62]

The major impact of *Connell* will probably be a significant decrease in the use of the hot cargo contract in the construction industry.[63] The accuracy of this prediction will be determined by future Board and federal court interpretations of the *Connell* Court's rationale concerning section 8(e). On one hand, *Connell* may be read not to invalidate a subcontracting agreement, irrespective of the union's motive for procuring the agreement, provided there is a collective bargaining relationship between the parties. Thus, the hot cargo agreement could retain some vitality because a union could predict when its conduct would be protected by the proviso under such an interpretation. Conversely, if the interpretation of *Connell* focuses upon the organizational motive of the union,[64] an agreement which was used

58. The secondary activities prohibited by section 8(b)(4) do not involve a combination between labor and non-labor groups. *See* notes 26 & 27 and accompanying text *supra*.

59. *See* note 28 *supra*.

60. The increased potential for harm where labor combines with non-labor concerns has been recognized since the *Hutcheson* decision in which the ability of a union to take advantage of the antitrust exemption depended upon its not combining with a non-labor group. *See* note 16 and accompanying text *supra*.

61. *See* National Woodwork Mfrs. Ass'n v. NLRB, 386 U.S. 612, 654–55 (Stewart, J., dissenting). It has further been suggested that this congressional preference for labor law remedies would apply even where a union had the direct purpose to restrict competition, as in Allen Bradley Co. v. Electrical Workers Local 3, 325 U.S. 797 (1945). National Woodwork Mfgrs. Ass'n v. NLRB, *supra* at 654–55.

62. 421 U.S. at 640–54 (Stewart, J., dissenting). However, the majority of the Court doubted that congressional inaction in 1947 and 1959 could be used to infer congressional intent in enacting section 8(e). *Id.* at 634–35 n. 16.

63. The treble damage provision of the Sherman Act, 15 U.S.C. § 15 (1970), should provide an effective deterrent to violations of section 8(e). Violations of sections 1 and 2 are also potentially punishable as a violation of the criminal law. 15 U.S.C. §§ 1, 2 (Supp. IV, 1975). Further, while a strike to procure a prohibited hot cargo clause might not be enjoinable under section 4 of the Sherman Act, 15 U.S.C. § 4 (1970), because it would constitute unilateral activity subject to the provisions of the Norris-LaGuardia Act forbidding the issuance of antitrust injunctions in such situations, *see* 29 U.S.C. §§ 101, 104 (1970), injunctive relief could nevertheless be obtained under section 10(1) of the NLRA, *id.* § 160(1).

64. This focus formed the foundation of the Court's holding that the nonstatutory exemption was unavailable, 421 U.S. at 623, 625–26, and that the agreement was not protected by the construction industry proviso to section 8(e). *Id.* at 631.

for organizational purposes would violate section 8(e) regardless of the fact that the parties had a collective bargaining relationship. This interpretation would serve to discourage hot cargo agreements because the union would probably not be willing to take the risk of predicting when the Board or the courts would find that its motive was organizational, and, more importantly, because in most, if not all, hot cargo agreements the union has some organizational motive.[65]

Connell indicates that the Supreme Court is continuing on its previous course of using antitrust sanctions against organized labor where a union combines with a non-labor group and does not act primarily to better the wages and working conditions of its members. *Connell* further indicates that the Court will employ the remedies of the antitrust laws to dissuade such union activity even where labor law remedies are available.

Kevin P. McKendry

SECURITIES LAW — COOPERATIVE APARTMENTS — SHARES OF A STATE-SUBSIDIZED NONPROFIT COOPERATIVE HOUSING CORPORATION DEEMED BEYOND THE SCOPE OF FEDERAL SECURITIES LAWS.

United Housing Foundation, Inc. v. Forman (U.S. 1975)

Plaintiff-respondents, 57 residents of Co-Op City,[1] filed a class action suit in the United States District Court for the Southern District of New

65. One could go further and say that all union actions are motivated by a desire to organize all the employees in the union's trade or industry. This desire to monopolize the representational rights of all employees has been one of the conceptual difficulties with applying the antitrust laws to organized labor. *See* Cox, *Labor and Antitrust — A Preliminary Analysis*, 104 U. PA. L. REV. 252, 254–56 (1956).

If, as the preceding suggests, union activity such as engaging in hot cargo agreements has some organizational motive in all cases, unions will be required to predict the degree of organizational motive which the Board and federal courts will allow. The difficulty which this drawing of somewhat arbitrary lines between a permissible and impermissible organizational motive will entail for organized labor will probably signal the end of the hot cargo clause.

1. Co-Op City is a large, nonprofit, low and middle income cooperative housing project in the Bronx, a Borough of New York City. United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 840 (1975). The project was organized and constructed under the New York State Private Housing Finance Law (Mitchell-Lama Act), N.Y. PRIV. HOUS. FIN. LAW §§ 11–37 (McKinney 1962), *as amended* (Supp. 1974–75), "enacted to ameliorate a perceived crisis in the availability of decent low-income urban housing." 421 U.S. at 840. "Eligibility [in Co-Op City] is limited to families whose monthly income does not exceed six times the monthly rental charge (or for families with three or more dependents, seven times the rental charge)." *Id.* at 841 n.1; *see* N.Y. PRIV. HOUS. FIN. LAW § 31(2)(a) (McKinney

York[2] on behalf of themselves and all other resident-tenants, alleging violations of their civil rights[3] and the antifraud provisions of the Securities Act of 1933[4] and the Securities Exchange Act of 1934[5] (Securities Acts) by the State of New York, two of its agencies,[6] and the corporate group that conceived, built, and controlled the project.[7] They contended that these violations stemmed from alleged misrepresentations[8] and material omissions[9] contained in an "Information Bulletin" circulated through the

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1962), *as amended* (Supp. 1974–75). Preference in admission must be given to veterans, the handicapped, and the elderly. *Id.* §§ 31(7)–(9).

To acquire an apartment in Co-Op City an eligible purchaser must buy 18 shares of stock in Riverbay (*see* note 6 *infra*) for each room desired at $25.00 per share. The shares are tied to the apartment and cannot be pledged, encumbered, bequeathed (except to a surviving spouse) or transferred to a nontenant. The residents of each apartment have one vote, regardless of the number of shares owned. Upon termination of occupancy, a tenant must offer his stock to Riverbay at the original cost; in the event that Riverbay does not repurchase, the tenant cannot sell his shares for more than their original price plus a fraction of the mortgage amortization that he has paid during his tenancy — and then only to a prospective tenant satisfying the income eligibility requirements. Under the Co-Op City lease arrangement, the resident is also committed to make monthly payments in accordance with the size, nature, and location of his apartment. 421 U.S. at 843.

2. Forman v. Community Servs., Inc., 366 F. Supp. 1117 (S.D.N.Y. 1973).

3. Plaintiff-respondents presented a claim against the New York State Private Housing Finance Agency under 42 U.S.C. § 1983 (1970).

4. 15 U.S.C. § 77q(a) (1970).

5. 15 U.S.C. § 78j(b) (1970); 17 C.F.R. § 240.10b-5 (1975) (rule 10b-5 promulgated under 15 U.S.C. § 78j(b) (1970)).

6. Pursuant to the Mitchell-Lama Act, the New York State Housing Finance Agency provided the bulk of the financing for the project through long-term, low-interest mortgage loans. New York State Division of Housing and Community Renewal, through its Commissioner, was responsible for the supervision of the development, construction, promotion, and operation of the project. *Id.* at 840–42; *see* N.Y. PRIV. HOUS. FIN. LAW §§ 11–37 (McKinney 1962), *as amended* (Supp. 1974–75).

7. Corporate defendants included United Housing Foundation (UHF), a nonprofit, membership corporation composed of labor unions, housing cooperatives, and civic groups, which initiated and sponsored the project; Riverbay, a nonprofit cooperative housing corporation, organized by UHF to own and operate the land and buildings and issue the stock that is the subject of the instant action; and Community Services, Inc. (CSI), UHF's wholly owned subsidiary and the project's general contractor and sales agent. 421 U.S. at 841–42.

8. The 1965 Co-Op City Information Bulletin informed prospective tenants that the total estimated cost of the project was $283,695,550 and that a $250,900,000 mortgage loan would be required to finance this construction price. Ultimately, the construction loan was $125 million more than the figure estimated in the 1965 Bulletin, causing the "average" monthly cost per-room to increase from the $23.02 per-room estimate given in the 1965 Bulletin to an actual figure of $39.68 per-room as of July, 1974. "The heart of respondents' claim was that the 1965 . . . Bulletin falsely represented that CSI would bear all subsequent cost increases due to such factors as inflation." 421 U.S. at 844. A copy of the 1965 Information Bulletin can be found in 2 P. ROHAN & M. RESKIN, COOPERATIVE HOUSING LAW AND PRACTICE app. D-8 (1973) [hereinafter cited as ROHAN & RESKIN].

9. Respondents maintained that the following material facts were omitted: (i) the original estimated cost had never been adhered to in any of the previous Mitchell-Lama projects sponsored by UHF and built by CSI; (ii) petitioners knew that the initial estimate would not be followed by the present project;

mail by the cooperative's sales agent. The district court dismissed the suit, holding that shares of Riverbay were not securities within the meaning of the Securities Acts,[10] but the Second Circuit Court of Appeals, taking a more flexible approach in defining a "security,"[11] reversed and remanded.[12] The Supreme Court of the United States reversed,[13] *holding* that shares of stock in a state-subsidized cooperative housing corporation, purchased as an incident of tenancy, were not "securities" within the purview of the federal securities laws. *United Housing Foundation, Inc. v. Forman,* 421 U.S. 837 (1975).

Whether a cooperative offering is covered by the Securities Acts requires an analysis of the definitional sections of these statutes to ascertain whether the shares in question are securities[14] or are beyond the scope of

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(iii) CSI was a wholly owned subsidiary of UHF; (iv) CSI's net worth was so small that it could not have been legally held to complete the contract within the original estimated costs; (v) the State Housing Commissioner had waived his own rule regarding liquidity requirements in approving CSI as the contractor; and (vi) there was an additional undisclosed contract between CSI and Riverbay. 421 U.S. at 844–45 n.8.

10. 366 F. Supp. at 1132. The district court rejected plaintiffs' argument that the denomination of the shares of Riverbay as "stock" meant that they were, a fortiori, securities. *Id.* at 1126–27. The court then held that they were not stocks because they did not represent any right to apportionment of tangible profits. *Id.* at 1127. Finally, the court asserted that the purchase in issue was not an "investment contract" since it was neither induced by an offering of tangible or material profits, nor could such profits realistically be expected. *Id.* at 1129. For a discussion of the expectation of profits requirement, *see* note 20 and accompanying text *infra.*

11. Forman v. Community Servs., Inc., 500 F.2d 1246 (2d Cir. 1974).

12. The court reached its decision by employing two alternative tests. Based upon a "literal" test, the offering was found to be within the ambit of the Securities Acts since the shares purchased were called "stock." *Id.* at 1252–53. Alternatively, the court concluded that the offering was an investment contract under the Securities Acts since profit was expected from three sources: 1) reduced carrying charges resulting from income generated from the leasing of commercial enterprises within the cooperative community; 2) the existence of tax benefits from pro rata deductions on mortgage interest payments; and 3) the monthly savings due to the fact that Co-Op City apartments were a less expensive form of property interest than comparable nonsubsidized housing. *Id.* at 1254.

The court further ruled that the immunity claims by the state parties were unavailing. It held that the state agency was independent and distinct from the state itself and therefore was a "person" for purposes of section 1983 (*see* note 3 *supra*); that both the agency and the state had waived immunity under section 32(5) of the Private Housing Finance Law, N.Y. PRIV. HOUS. FIN. LAW § 32(5) (McKinney 1962), *as amended* (Supp. 1974–75); and that the state also implicitly waived its immunity by voluntarily participating in the sale of securities, an area subject to plenary federal regulation. 500 F.2d at 1255–56.

13. Mr. Justice Powell delivered the opinion of the Court in which Chief Justice Burger and Justices Stewart, Marshall, Blackmun, and Rehnquist joined. 421 U.S. at 840. Mr. Justice Brennan filed a dissent in which Justices Douglas and White joined. *Id.* at 860 (Brennan, J., dissenting).

Due to the manner in which the case was resolved, the Court did not have to address the issue of the validity of the immunity claims presented by the state. *Id.* at 841 n.11.

14. Section 2(1) of the Securities Act of 1933 provides in pertinent part:

When used in this subchapter, unless the context otherwise requires — (1) the term "security" means any note, stock . . . certificate of interest or participation

securities legislation.[15] Although this problem of statutory construction has plagued the federal courts for quite some time, the Supreme Court, prior to the instant case, has only considered the definition of the term "security" upon a few occasions since 1933.[16]

In *SEC v. C.M. Joiner Leasing Corp.*,[17] the Supreme Court, interpreting the definitional language of the 1933 Act for the first time, articulated a test for determining the existence of a security without attempting to enumerate a security's constituent elements. The Court held that the character given to the instrument by the offering's terms, the plan of distribution, and the economic inducements to the prospective purchaser should determine whether it constitutes a security.[18] Three years later, in *SEC v. W.J. Howey Co.*,[19] Justice Murphy, speaking for the majority, isolated the elements which were the distinctive features of an "investment contract": an investment in a common enterprise with an expectation of profits derived solely from the efforts of third parties.[20]

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in any profit-sharing agreement, . . . investment contract, . . . or, in general, any interest or instrument commonly known as a "security" . . . .

15 U.S.C. § 77b(1) (1970).

The Securities Exchange Act of 1934 contains a slightly different definition of a security. *See* Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1970). However, in Tcherepnin v. Knight, 389 U.S. 332 (1967), the Supreme Court ruled that the definitions were "virtually identical." *Id.* at 336.

15. Congress did not attempt to articulate the relevant economic criteria for distinguishing "securities" from "non-securities" when it provided the definitions of "security" in the Securities Act of 1933. It sought instead to define "the term 'security' in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security." H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933). There is a substantial question as to whether a promoter of a housing cooperative must register the cooperative shares with the SEC. *See* Miller, *Cooperative Apartments: Real Estate or Securities?*, 45 B.U. L. REV. 465, 496–503 (1965). *See also* Hammon & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L.J. 219 (1974).

16. *See* Tcherepnin v. Knight, 389 U.S. 332 (1967) (withdrawable capital shares in a savings and loan association ruled securities); SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967) (flexible fund annuity contract ruled an investment contract); SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65 (1959) (variable annuity contract ruled an investment contract); SEC v. W.J. Howey Co., 328 U.S. 293 (1946) (sale of citrus groves with a contract for care and development ruled an investment contract); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943) (sale of oil lease assignments along with exploration contracts ruled an investment contract).

The Supreme Court has indicated that the definitional provisions of the Securities Acts are to be construed broadly to effectuate the statutes' remedial purposes. Tcherepnin v. Knight, *supra* at 336, 338; *see* SEC v. W.J. Howey Co., *supra* at 298.

17. 320 U.S. 344 (1943).

18. *Id.* at 352–53.

19. 328 U.S. 293 (1946). This is considered to be the landmark case defining investment contracts. 1 L. Loss, SECURITIES REGULATION 483 (2d ed. 1961) [hereinafter cited as Loss].

20. 328 U.S. at 298–99. The Court noted that it was "immaterial whether the shares in the enterprise are evidenced by formal certificates." *Id.* at 299. This test has been broken down into four basic elements: (i) investment of money, (ii) in a common enterprise, (iii) with the expectation of profits, (iv) arising solely from the efforts of others. *See* Coffey, *The Economic Realities of a "Security": Is There a*

Fifteen years after *Howey,* the Supreme Court of California, in *Silver Hills Country Club v. Sobieski,*[21] made the first major departure from Justice Murphy's well-established definition of an investment contract. Writing for the court, Justice Traynor rejected a profit expectation analysis and adopted instead a "risk capital" approach under which an investor is entitled to the protection of the securities laws if he risks capital, whether or not he expects any monetary return.[22] This opinion, described by one

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More Meaningful Formula?, 18 CASE W. RES. L. REV. 367 (1967); Hannon & Thomas, *supra* note 15, at 225 n.28; Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation,* 24 OKLA. L. REV. 135, 142 (1971).

The first two elements of the *Howey* test — an investment of money and a common enterprise — are always present in a cooperative housing venture; the sharing of control and expense by the tenant-shareholders constitutes a common scheme. *See* Miller, *supra* note 15, at 467. However, the third requirement, that profits be expected, is rarely found in transactions involving shares of cooperative housing stock. *Id.* at 474.

Most state courts faced with questions involving the applicability of state security acts (blue sky laws) to cooperative corporations have held that cooperative housing shares constitute an interest in realty and not a security and are thus exempt from the registration requirements of state statutes. ROHAN & RESKIN, *supra* note 8, § 3.03(3); *see, e.g.,* Willmont v. Tellone, 137 So. 2d 610 (Fla. Dist. Ct. App. 1962) (sale of stock in a cooperative without a permit ruled not a violation of the state securities statute); Brothers v. McMahon, 351 Ill. App. 321, 115 N.E.2d 116 (1953) (shares of cooperative were "merely mechanical incidents to the basic contract which was for the sale of an interest in real estate," *id.* at 326, 115 N.E.2d at 118, and thus not subject to blue sky law); State v. Silberberg, 166 Ohio St. 101, 139 N.E.2d 342 (1946) (sale of cooperative stock constituted sale of real estate and transaction was thus not subject to state securities law).

Some courts have applied the latter portion of *Howey* literally. *See, e.g.,* Mr. Steak, Inc. v. River City Steak, Inc., 460 F.2d 666 (10th Cir. 1972) (franchise scheme not an investment contract though franchisee had no effective control, since plan envisioned that franchisee would have flexible role); SEC v. Koscot Interplanetary, Inc., 365 F. Supp. 588 (N.D. Ga. 1973) (pyramid scheme not an investment contract, since investors' expected profit would not come solely from the efforts of a promoter).

However, an increasing number of courts, dissatisfied with this approach, have interpreted these elements more expansively. *See, e.g.,* Andrews v. Blue, 489 F.2d 367 (10th Cir. 1973) ("in name only" management role of investor satisfies the third-party management test); SEC v. Glenn W. Turner Enter., Inc., 474 F.2d 476 (9th Cir.), *cert. denied,* 414 U.S. 821 (1973) (element of third-party management is present even though undeniably significant managerial efforts are made by investor); Davenport v. United States, 260 F.2d 591 (9th Cir. 1958), *cert. denied,* 359 U.S. 909 (1959) (job security a sufficient "profit"); SEC v. American Found'n for Advanced Educ., 222 F. Supp. 828 (W.D. La. 1963) (assurance that investors' children will have financial capability to attend college a sufficient "profit").

21. 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961). The court held that a membership which gave the purchaser the right to use country club facilities to be built with the investor's money, but in which he was to have no legal interest, conferred sufficient benefit to make the membership a security. *Id.* at 815–16, 361 P.2d at 908–09, 13 Cal. Rptr. at 188–89.

22. *Id.* at 815–16, 361 P.2d at 908–09, 13 Cal. Rptr. at 188–89. Justice Traynor reasoned that:

> We have here nothing like the ordinary sale of a right to use existing facilities. Petitioners are soliciting the risk capital with which to develop a business for profit. [The promoters were to receive any profit left over from the construction and operation of the club facilities.] The purchaser's risk is not lessened merely because the interest he purchases is labelled a membership. Only because he risks his capital along with other purchasers can there be any chance that the benefits of club membership will materialize.

Id. at 815, 361 P.2d at 908, 13 Cal. Rptr. at 188; *see* note 21 *supra.*

commentator as a "chink in the armor"[23] of the *Howey* profit requirement, has subsequently been adopted by several state courts.[24]

Prior to the Supreme Court's decision in the instant case, the Securities and Exchange Commission (SEC) had taken an equivocal position concerning whether cooperative housing shares were securities. SEC Rule 235, exempting cooperative housing corporations from the registration requirements of the Securities Acts under certain specified conditions, had been interpreted as implying that all cooperative shares were securities unless exempted.[25] However, this reading of the rule had not been vali-

23. Miller, *supra* note 15, at 477.

24. One of the most influential of the recent cases seeking to redefine *Howey* is State Comm'r of Securities v. Hawaii Market Center, Inc., 52 Hawaii 642, 485 P.2d 105 (1971). In this case, the Supreme Court of Hawaii rejected the *Howey* test as too restrictive and mechanical and reformulated the definition of "investment contract" as follows:

> (1) An offeree furnishes initial value to an offeror, and
> (2) a portion of this initial value is subjected to the risks of the enterprise, and
> (3) the furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and
> (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.

Id. at 649, 485 P.2d at 109.

The court acknowledged that this test was suggested by Professor Coffey in his article analyzing the essential economic characteristics of security transactions. *Id.* at 648 n.5, 485 P.2d at 109 n.5, *citing* Coffey, *supra* note 20, at 377. Professor Long has also developed a definition of a security by specification rather than by enumeration. Long, *supra* note 20, at 159–74. *See also* Long, *Introduction to Symposium: Interpreting the Statutory Definition of a Security: Some Pragmatic Considerations,* 6 ST. MARY'S L.J. 96, 114–28 (1974). For a comparison of these two proposed tests, *see* Long, *supra* note 20, at 174 n.170.

25. 17 C.F.R. § 230.235 (1973).

SEC Rule 235 exempts cooperative housing corporations from the registration requirements of the Securities Acts if: 1) the corporation engages in no business activity other than owning and leasing residential property, except that such other businesses are allowable if "incidental" to owning and leasing residences; 2) the corporation permits transfers of stock only in connection with transfers of leases; and 3) the total amount of stock offered to the public within any 12-month period may not exceed $300,000. 17 C.F.R. § 230.235 (1973).

Some commentators have suggested that the SEC would not have exempted *certain types* of cooperative housing stock from registration unless it believed that *all* cooperative shares were securities. *See, e.g.,* Note, *Cooperative Housing Corporations and the Federal Securities Laws,* 71 COLUM. L. REV. 118, 127 (1971). However, Professor Loss has stated that "it would be too facile to argue that this proves conclusively that such shares are securities under either the 1933 act or the 1934 act." Loss, *supra* note 19, at 493–94.

The SEC's recent policy statement dealing with the applicability of the Securities Acts to the offer and sale of interests in real estate is SEC Securities Act Release No. 5347, 38 Fed. Reg. 1735 (1973). Release No. 5347 deals with "condominiums and other units," stating that while the offer of real estate as such does not involve the offer of a security, an investment security may nevertheless be present where the real estate is offered in conjunction with certain services. *Id.* The release indicates:

> [T]he offering of *condominium units* in conjunction with any one of the following will cause the offering to be viewed as an offering of securities in the form of investment contracts:
>
> 1. The *condominiums,* with any rental arrangement or other similar service, are offered and sold with emphasis on the economic benefits to the pur-

dated by any further SEC release. To further this confusion, it was not clear whether the recent SEC policy statement dealing with the application of the Securities Acts to real estate transactions — Release No. 5347 — was applicable to cooperative housing ventures.[26]

In response to this judicial and administrative uncertainty concerning the status of cooperative housing shares under the federal securities laws, the Supreme Court granted *certiorari* in the instant case to address itself to the problems inherent in this relatively new area of the law.[27] The Court's analysis began with a brief discussion of the legislative history of the definitional section of the Securities Act of 1933,[28] and the purposes which the federal securities laws were designed to serve, *i.e.*, to eliminate abuses in the trading of securities.[29] In determining whether shares of Riverbay stock constituted "securities" within the meaning of these acts, the Court refused to adopt the "literal approach" urged upon it by the respondents and instead applied a substantive analysis.[30] Undertaking an

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chaser to be derived from the managerial efforts of the promoter, or a third party designated or arranged for by the promoter, from rental of the units.

2. The offering of participation in a rental pool arrangement; and
3. The offering of a rental or similar arrangement whereby the purchaser must hold his unit available for rental for any part of the year, must use an exclusive rental agent or is otherwise materially restricted in his occupancy or rental of his unit.

Id. at 1736 (emphasis added).

The release further indicates that the Securities Acts are inapposite to situations where commercial facilities are a part of the common elements of a residential project, if

> (a) the income from such facilities is used only to offset common area expenses and (b) the operation of such facilities is incidental to the project as a whole and . . . not established as a primary income source for the individual owners of a condominium *or cooperative unit.*

Id. (emphasis added).

It is unclear whether the SEC's reference to "other units" includes cooperatives; although the Commission expressly refers to "cooperative units" at one point, the primary focus of the release appears to be on condominiums. *See generally* Berman & Stone, *Federal Securities Law and the Sale of Condominiums, Homes, and Homesites,* 30 BUS. LAW. 411, 420–25 (1975).

If the release is read as applying only to condominiums, Rule 235 becomes the sole embodiment of the SEC's views with respect to cooperative housing corporations. If Release No. 5347 does apply to cooperatives, shares of cooperative stock would not be considered securities unless the offering fit into one of the three aforementioned categories. The SEC has yet to clarify this dilemma, despite the fact that its own advisory committee on real estate has recommended that any differences between condominiums and cooperatives are illusory for purposes of securities analysis. *See* SEC, REPORT OF THE REAL ESTATE ADVISORY COMMITTEE TO THE SECURITIES AND EXCHANGE COMMISSION 1, 89–91 (1972).

26. 38 Fed. Reg. 1735 (1973); *see* note 25 *supra.*

27. 421 U.S. at 847.

28. *Id.* at 847–48 & n.12, *citing* S. REP. No. 792, 73d Cong., 2d Sess. 14 (1934), *and* H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933).

29. 421 U.S. at 849.

30. The Court ruled that the name given to an instrument, although not irrelevant, was still not dispositive. *Id.* The Court also noted that respondents' reliance upon *Joiner* (*see* text accompanying notes 17 & 18 *supra*) as support for a literal approach in defining a security was misplaced. *Id.* at 849–50. For a further discussion of the Court's analysis of *Joiner, see* notes 47 & 48 and accompanying text *infra.*

examination of the economic realities of the transaction, the Court concluded that the shares in question were not within the coverage of the Securities Acts.[31]

In analyzing the validity of the Second Circuit's decision that a share of Riverbay was an "investment contract," the Court applied the *Howey* definition[32] and determined that the "nonprofit" nature of Co-Op City precluded this finding.[33] In so ruling, the Court necessarily dismissed the three sources of "profit" upon which the Second Circuit had based its determination that the transaction had in fact satisfied the *Howey* requirements.[34] The Supreme Court then distinguished securities and consumer goods, placing the Riverbay shares in the latter grouping and ruling that they were beyond the scope of the Securities Acts.[35] In the words of the Court, "[T]he inducement [for a tenant] to purchase [these shares] was solely to acquire subsidized low-cost living space; it was not to invest for profit."[36]

Respondents attempted to circumvent the *Howey* profit requirement by urging that the Court adopt the "risk capital" approach articulated by the California Supreme Court in *Silver Hills*.[37] The Court, however, refused to address this argument and further stated that, even if they were to adopt the California rule, it would not apply in this case since the purchase of apartments does not involve "the kind of risk of 'fluctuating' value associated with securities investments."[38] For these reasons the Supreme

31. 421 U.S. at 858. The Court ruled that the Riverbay shares lacked the most common feature of stock: "the right to receive dividends contingent upon an apportionment of profits." *Id.* at 851, *citing* Tcherepnin v. Knight, 389 U.S. 332, 339 (1967). Continuing in this vein, the Court bolstered its finding by ruling that the shares also lacked other characteristics commonly associated with stock: they were not negotiable; they could not be pledged or hypothecated; they conferred no voting rights in proportion to the number of shares owned; and they could not appreciate in value. 421 U.S. at 851.

32. For a discussion of the *Howey* definition of an investment contract, *see* notes 19 & 20 and accompanying text *supra*.

33. The Court noted that, in reference to "profits," the Supreme Court has generally meant either capital appreciation resulting from the development of the initial investment or participation in earnings resulting from the use of investors' funds. 421 U.S. at 852.

34. *Id.* at 854–57. The Court reached the following conclusions. First, tax deductions for the portion of the monthly rental charges allocable to interest payments on the project's mortgage were not "profits," and, that even if these deductions *were* considered "profits," they did not result from the managerial efforts of others. Second, the net income, if any, derived from the leasing by Co-Op City of commercial facilities, professional offices, and parking spaces, and its operation of community washing machines, to be used to reduce rental costs, was far too speculative and insubstantial to bring the entire transaction within the Securities Acts. The Court also observed that these facilities had been established, not for profit, but to provide essential services to residents of the huge complex. Third, savings based on the fact that Co-Op City offered housing at a cost substantially below the going rental charges no more embodied income or profit attributes than did other types of government subsidies. *Id.*

35. *Id.* at 852–53.

36. *Id.* at 851.

37. *Id.* at 857 n.24. For a discussion of the *Silver Hills* opinion, *see* notes 21 & 22 and accompanying text *supra*.

38. 421 U.S. at 857 n.24.

Court found that the transaction was not covered by the federal securities laws and that respondents' claims were therefore not cognizable in federal court.[39]

Mr. Justice Brennan, writing for the dissent, concluded that the Riverbay interests constituted securities because they were both "stock" and "investment contracts."[40] Expressing approval of each form of "profit" set forth by the Second Circuit,[41] he objected to the majority's observation that "profits" cannot assume forms other than appreciation of capital or participation in earnings.[42] He continued by strenuously attacking the majority's ruling that the nonprofit nature of Co-Op City precluded the application of the securities laws.[43] In conclusion, Justice Brennan remarked that, until a different form of redress was devised to deal with cooperative housing shares, investors in such stocks could not be denied the protection which in his opinion the current securities laws plainly allowed.[44]

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39. Due to its holding that there was no federal jurisdiction, the Court did not address the merits of respondents' allegations of fraud. The Court also expressed no opinion concerning whether the sale of cooperative shares *should* be protected by federal securities regulation. *Id.* at 859.

40. *Id.* at 860 (Brennan, J., dissenting). In so concluding, Justice Brennan was compelled to answer the immunity defenses asserted by the State of New York and the New York State Housing Finance Agency. The Second Circuit found such defenses unavailing, and Justice Brennan agreed with this result. *Id.* at 866 n.6. For a discussion of this aspect of the Second Circuit's holding, *see* note 12 *supra.*

41. 421 U.S. at 861–63. For a summary of the majority's analysis of these elements, *see* note 34 *supra.*

Beginning with the leasing of commercial and office space, Justice Brennan noted that revenues well in excess of $1 million per year flowed into the corporation from such activities. He concluded that, even after deductions for taxes and expenses, the residue could hardly be de minimis. He further characterized as fallacious the majority's statement that this aspect of the corporation's activities was "speculative and insubstantial." 421 U.S. at 861.

Turning to the "profits" resulting from the low cost of Co-Op City housing, Justice Brennan objected to the majority's holding that the low rent derived solely from substantial financial subsidies provided by the State of New York; rather, he contended that management efficiency also entered into the equation. Justice Brennan also noted that to the extent that tenant-shareholders *did* benefit in reduced charges from government subsidies, this did not make these benefits any less a "profit" to them. *Id.* at 861–62.

Justice Brennan finally addressed the last purported source of "profits" to Co-Op City residents — the tax deductibility accorded to portions of their monthly carrying charges. Although agreeing with the majority that these tax benefits were the equivalent of those available to any homeowner, Justice Brennan distinguished the two by asserting that the "profit" of the individual homeowner did not result "solely from the efforts of others," whereas the "profit" from this source realized by a Co-Op City resident did. These efforts were those of Co-Op City's management in organizing and operating the project to realize the tax benefits for them. *Id.* at 862–63.

42. *Id.* at 863, *citing* P. SAMUELSON, ECONOMICS 618–26 (9th ed. 1973). Justice Brennan further stated that all of the varieties of profit involved in the instant case accrued to the tenant-shareholders in the form of money saved rather than money earned. 421 U.S. at 863.

43. 421 U.S. at 867–68.

44. Id. at 868. He also remarked that the Securities and Exchange Commission agreed with his position. *Id.* at 869.

The Court's initial rejection of a literal reading of "stock" can be supported by traditional canons of statutory construction[45] as well as by prior judicial authority.[46] In citing dictum from *Joiner* to support its application of a literal approach,[47] the Second Circuit had unfortunately ignored the remainder of this opinion wherein the *Joiner* Court emphasized the importance of considering an instrument within the context of the entire transaction.[48] Consequently, the Supreme Court's position on this matter represented a welcome return to the accepted practice of disregarding form for substance, and of emphasizing the economic realities of the situation.[49]

In determining whether Riverbay stock was an "investment contract" under *Howey,* the Court limited the profit expectation requirement solely to a *monetary return.*[50] In doing this, the Court clearly rejected the Second Circuit's expansive interpretation of "profit."[51] The Court summarily disposed of the Second Circuit's reliance on tax benefits from pro-rata deductions on mortgage payments, asserting that they knew of "no

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45. The Supreme Court has long recognized "that a thing may be within the letter of the statute and yet not within the statute, because not within . . . the intention of its makers." Church of the Holy Trinity v. United States, 143 U.S. 457, 459 (1892).

46. "With the exception of the Second Circuit, every Court of Appeals recently to consider the issue has rejected the literal approach urged by respondents." 421 U.S. at 849 n.14. The Seventh Circuit, for example, drew a distinction between commercial and investment notes and held that commercial notes were beyond the realm of the Securities Acts. C.N.S. Enter., Inc. v. G.&G. Enter., Inc., 508 F.2d 1354, 1362–63 (7th Cir. 1975). The Fifth Circuit has also distinguished between investment notes and commercial notes, asserting jurisdiction over only the former. McClure v. First Nat'l Bank, 497 F.2d 490, 494–95 (5th Cir. 1974), *cert. denied,* 420 U.S. 930 (1975); Bellah v. First Nat'l Bank, 495 F.2d 1109, 1113 (5th Cir. 1974). The Third Circuit, emphasizing that all the definitions in the Securities Acts were prefaced by the words, "unless the context so requires," found that certain promissory notes were not securities because they were not the kind of notes Congress intended to cover. Lino v. City Inv. Co., 487 F.2d 689, 694 (3d Cir. 1973).

47. 500 F.2d at 1252, *citing* SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943).

48. The *Joiner* Court noted that other rules of statutory construction

> long have been subordinated to the doctrine that courts will construe the details of an act in conformity with its dominating general purpose, will read text in the light of context and will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy.

320 U.S. at 350–51 (footnote omitted).

49. *See* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946). The Second Circuit had observed:

> [W]here one utilizes the outward and traditional manifestations of a "stock" organization, the buyer may be led to believe that what he is buying is "stock" as normally considered and which would be protected by the federal or state securities laws. Indeed, the buyer of the purported "stock" may rely to some extent on the notion that he will at least be protected by those laws.

500 F.2d at 1252; *see* note 30 and accompanying text *supra.*

50. For a statement of the majority's definition of "profit," *see* note 33 *supra.* For a summary of Justice Brennan's criticism of this position, *see* note 42 and accompanying text *supra.*

51. As one commentator has succinctly written: "[I]n its attempt to spear Co-Op City with the *Howey* test, the Second Circuit has badly bent [the profit] prong of the test." 53 TEXAS L. REV. 623, 630 (1975).

basis in law for the view that the payment of interest, with its consequent deductibility for tax purposes, constitutes income or profits."[52] Although the Court conceded that reduced carrying charges resulting from the leasing of commercial enterprises upon the premises were conceptually "the kind of profit traditionally associated with a security investment,"[53] it felt that the income from this source in the instant case was "far too speculative and insubstantial to bring the entire transaction within the Securities Acts."[54] In order to obtain the aforementioned tax deductions, no more than 20% of the corporation's income could be derived from such outside sources.[55] Thus, it is unlikely that this source of income could ever provide a substantial "profit" to any of Co-Op City's tenant-shareholders. The last form of "profits" mentioned by the Second Circuit derived from Co-Op City's offering of apartments at a cost substantially below the going rental charges for comparable housing. However, the low rent resulted from the substantial financial subsidies provided by the State of New York, a fact pointed out by the majority,[56] and, as such, was not a source of "profit" within the *Howey* rationale.

The Court declined to discuss the "risk capital" approach enunciated in *Silver Hills*,[57] reasoning that since Co-Op City tenant-shareholders could recover their initial investment in full if dissatisfied with their apartments, they had undertaken no material risk.[58] As Co-Op City could arguably be distinguished from the more typical cooperative housing development in this respect, the fact that the "risk capital" analysis was not appropriate in the Co-Op City situation does not mean that it could not be correctly applied in another setting. Unfortunately, the *Forman* Court's failure to reach the "risk capital" issue prevented it from providing a much-needed judicial gloss for future courts faced with the problems inherent in this area of the law.

Had the Court felt compelled to address the "risk capital" concept, it might have enunciated the criteria relevant to the application of this approach. A fertile starting point for this analysis would have been a discussion of the more representative cooperative housing project — one in

52. 421 U.S. at 855.

53. 421 U.S. at 856, *citing* Tcherepnin v. Knight, 389 U.S. 332 (1967).

54. 421 U.S. at 856.

55. *See* INT. REV. CODE OF 1954, § 216(b)(1)(D). Furthermore, by statute, these facilities could only be "incidental and appurtenant" to the housing project. *See* N.Y. PRIV. HOUS. FIN. LAW § 12(5) (McKinney 1962), *as amended* (Supp. 1974–75). In addition, if SEC Release No. 5347 applies to cooperative housing developments, profits from these commercial rentals would have to be "incidental" to the cooperative itself in order for the cooperative to be exempt from the registration requirements of the Securities Acts. For a summary of the SEC's position on this matter, *see* note 25 *supra*.

56. 421 U.S. at 855. Justice Brennan strenuously objected to this reasoning. *Id.* at 861–62 (Brennan, J., dissenting).

57. For a detailed summary of this case, *see* note 21 and accompanying text *supra*.

58. 421 U.S. at 857 n.24. Co-Op City was an atypical cooperative housing project due to the fact that it was subsidized by the State of New York and was therefore subject to certain prohibitions not present in privately financed developments. The prohibition against the resale of cooperative stock at a profit was one such restriction. *Id.* at 842–43. For a discussion of other such provisions, *see* note 1 *supra*.

which capital gain upon resale of cooperative shares is allowed by the governing corporate body.[59] The typical purchaser of these shares does undertake a risk since he stands to lose his initial investment should it become impossible for him to resell his shares or should the corporation go bankrupt.[60] Consequently, the *Silver Hills* "risk capital" approach might very well apply to the private cooperative housing transaction.[61]

The Court declined to discuss another issue which has vexed the lower courts for quite some time, namely, whether the *Howey* requirement that profits come "solely from the efforts of others" is to be read literally or

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59. 1050 Tenants Corp. v. Jakobson, 503 F.2d 1375 (2d Cir. 1974), *aff'g* 365 F. Supp. 1171 (S.D.N.Y. 1973), a Second Circuit case closely related to *Forman,* is illustrative of a federal court's treatment of a privately financed cooperative housing venture. In this case, a cooperative corporation and its shareholders alleged violations of the antifraud provisions of the Securities Acts by the former owner-promoters who had converted the building from rental to cooperative apartments. 503 F.2d at 1376. Relying heavily upon its prior decision in *Forman,* the Second Circuit held that a share in 1050 Corporation was both "stock" and an "investment contract" under the federal securities laws. *Id.* at 1378. In discussing the requirement that there be an expectation of "profits" or "economic inducements," the court ruled that the three elements found to have been sufficient in *Forman* were likewise present and adequate in the *1050 Tenants* situation, namely: 1) nonresidential income used by the corporation to reduce monthly carrying charges; 2) substantial savings on personal income taxes in the form of deductions for proportionate shares of the corporation's deductible expenses; and 3) receipt of optimum services at the lowest possible cost. *Id.* Importantly, the court next added a fourth "profit" element that was notably absent in *Forman: "the shareholder-tenants of the 1050 Corporation ha[d] the expectation of capital appreciation on a resale of their stock." Id.* (emphasis added).

The Supreme Court focused primarily on the nonprofit nature of Co-Op City in ruling that the transaction in *Forman* was beyond the scope of the federal securities laws. It appears likely that where a profit element is present, a court will find that the transaction *does* involve the "fluctuating value" type of risk which brings an investment within the ambit of federal securities legislation. *See* text accompanying note 38 *supra.* The presence of a profit motive in most privately financed cooperative ventures would therefore seem to bring this form of cooperative project within the protection of the Securities Acts, even though nonprofit, state-subsidized cooperatives are not similarly protected. The presence of a profit motive also seems to be a determinative factor in situations other than those involving cooperative housing ventures. *Cf.* SEC v. Bailey, 41 F. Supp. 647 (1941) (contracts for the sale of small tracts of land said to be suited for the cultivation of tung trees, whereby the corporation selling the land agreed to cultivate the groves for the purchaser, deemed to be investment contracts since investors were actually attracted by the income to accrue from the groves); Hacker v. Goldberg, 263 Ill. App. 73 (1931) (membership in a country club not a security where members had no right to share in the profits of the corporation). In two other cases it was found that a contract of membership in an association which gave the member the right to purchase goods from the association at a stipulated percentage above cost, but which did not give the member the right to share in the profits of the company, was not a security. *See* Lewis v. Creasey Corp., 198 Ky. 409, 248 S.W. 1046 (1923); Creasey Corp. v. Enz Bros. Co., 177 Wis. 49, 187 N.W. 666 (1922).

60. Due to the fact that the State of New York had financed over 92% of the cost of construction and had carefully regulated the development and operation of Co-Op City, the Supreme Court felt that the chance of this project going bankrupt was an "unrealistic possibility." 421 U.S. at 857 n.24.

61. Since Justice Brennan found the profit expectation element of *Howey* satisfied in the instant case, it was not necessary for him to discuss the *Silver Hills* "risk capital" analysis.

in a more flexible manner.[62] The Court noted that the Ninth Circuit had construed the word "solely" in the latter sense, but refused to comment upon this holding, asserting that this particular issue had not been presented in the instant case.[63] However, this question was presented in *Forman* and the Court might have dispelled the uncertainty surrounding the proper construction of this part of the *Howey* test by addressing this issue. When discussing whether tax deductions to tenant-shareholders constituted a form of "profit" under *Howey,* the Court remarked that "[e]ven if these tax deductions were considered profits, they would not be the type associated with a security investment *since they d[id] not result from the managerial efforts of others."*[64] Similarly, in dismissing the second source of "profit" articulated by the Second Circuit — that the lower rental costs at Co-Op City were a profit to the tenant-shareholders — the Court stated that "[t]his [was] an inappropriate theory of 'profits'. . . . This benefit [could] not be liquidated into cash; *nor [did] it result from the managerial efforts of others."*[65] In both of these instances the Court applied the *Howey* requirement that "profits" must come "solely from the managerial efforts of others."[66] Unfortunately, however, the Court failed to explain the standard which it employed in either defining or applying the "solely" portion of this test. On the other hand, Justice Brennan had no difficulty in finding that all three forms of profit articulated by the Second Circuit came "solely from the efforts of third parties" — namely, the Co-Op City management.[67]

The final deficiency in the majority opinion lies in the manner in which the Court summarily dismissed as insignificant the amicus curiae brief submitted by the SEC.[68] The Court explained its action by remarking that while "[t]raditionally the views of an agency charged with administering the governing statute would be entitled to considerable weight," the fact that the brief was diametrically opposed to the SEC's position in Release No. 5347 militated against this traditional deference.[69] Since it is far from certain that this release even applies to cooperative ventures,[70] the Court was arguably too cursory in its dismissal of the brief. Furthermore, assuming the Court was correct in its belief that Release No. 5347 is relevant to cooperatives, the possibility still existed that the SEC had changed its position since the publication of this release.[71]

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62. For a discussion of how some lower courts have addressed this problem, *see* note 20 *supra.*

63. 421 U.S. at 852 n.16, *citing* SEC v. Glenn W. Turner Enter., Inc., 474 F.2d 476, 482, *cert. denied,* 414 U.S. 821 (1973); *see* note 20 and accompanying text *supra.*

64. 421 U.S. at 855 n.20 (emphasis added).

65. *Id.* at 855 (emphasis added).

66. *See* note 20 and accompanying text *supra.*

67. 421 U.S. at 861–63 (Brennan, J., dissenting).

68. *Id.* at 858 n.25.

69. *Id.*

70. For a detailed analysis of this release, *see* note 25 *supra.*

71. This appears to be the position taken by Justice Brennan in his dissenting opinion. *See* note 44 *supra.*

In view of the fact that Co-Op City is not a representative housing project,[72] it is doubtful that the instant decision will have a significant impact on the cooperative housing field. Since most of the Court's objections to applying the Securities Acts to cooperative housing shares seem related to the unique factual situation presented by Co-Op City,[73] this opinion would not seem to foreclose the possibility that shares of stock in some privately owned cooperatives could fall within the ambit of federal securities legislation.[74] Furthermore, as the *Forman* Court refused to address the frequently litigated issues of "risk capital" and the breadth of the *Howey* "solely" requirement,[75] the opinion will inject no order into these very unsettled areas of the law.

While the Court correctly concluded that Co-Op City purchasers were not intended to be safeguarded by the Securities Acts, it is submitted that some measure of protection should be afforded these individuals. The major impact which *Forman* may conceivably have is in spurring Congress into enacting legislation to deal with the many problems unique to the cooperative housing industry. This prediction is based upon language in the opinion wherein the Court expressed its reluctance to extend the securities laws to real estate transactions, reasoning that this task was better left to Congress.[76] It is hoped that Congress will soon accept this challenge and enact legislation to provide for the regulation of the large variety of cooperative housing schemes that are cropping up throughout the nation.[77]

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72. *See* note 58 *supra.*

73. These objections were the lack of a profit element in *Forman,* 421 U.S. at 854–57, and the fact that "investors" in Co-Op City could receive a full return of their investment upon resale of their cooperative shares. *Id.* at 857 n.24.

74. *See* notes 59–61 and accompanying text *supra.*

75. *See* notes 58–67 and accompanying text *supra.*

76. 421 U.S. at 859 n.26.

77. The Court observed that Congress only recently instructed the Secretary of Housing and Urban Development "to conduct a full and complete investigation and study . . . with respect to . . . the problems, difficulties and abuses or potential abuses applicable to condominium and cooperative housing." *Id., citing* Act of August 22, 1974, Pub. L. No. 93–383, § 821, 88 Stat. 740.