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ENVIRONMENTAL LAW — WATERSHED PROTECTION AND FLOOD PREVENTION ACT — UNDER SECTION 5, A MULTIDAM PROJECT MAY BE TREATED AS A SINGLE UNIT FOR PURPOSES OF COMPUTING A COST/-BENEFIT RATIO.

Concerned Residents v. Grant (1976)

As a result of frequent flooding in the Brodhead Creek area of the Pocono Mountains in northeastern Pennsylvania, local government officials sought federal assistance[1] under the Watershed Protection and Flood Prevention Act (Watershed Act)[2] to build four floodwater detention dams.[3] After the project application was approved,[4] a work plan[5] describing the project was prepared by the local officials and the Soil Conservation Service of the Department of Agriculture (SCS) and submitted to the appropriate congressional committees for approval.[6] Although the approval was received,[7] delays ensued that necessitated the preparation of a supplemental work plan.[8] As required under the Watershed Act, both the original and

1. The county commissioners of Monroe and Pike counties applied for federal aid in 1958. Concerned Residents v. Grant, 537 F.2d 29, 31 (3d Cir. 1976).

2. 16 U.S.C. §§ 1001–1009 (1970 & Supp. V 1975). Section 4 sets forth the conditions which must be met in order to obtain federal assistance under the Watershed Act. *See id.* § 1004.

3. 537 F.2d at 31. A flood in August 1955, which claimed nine lives and caused severe property damage, prompted local officials to attempt to remedy the situation. *Id.* at 31 n.1.

4. The governor of Pennsylvania approved the application for the project, pursuant to section 3 of the Watershed Act, 16 U.S.C. § 1003 (1970 & Supp. V 1975). 537 F.2d at 31 n.1.

5. The Watershed Act does not *expressly* provide that a work plan must be prepared. However, the frequent references to a "plan" seemingly indicate that one is envisioned as a component of programs instituted under the Watershed Act. *See* 16 U.S.C. §§ 1002, 1003, 1005 (1970 & Supp. V 1975). The work plan prepared in the instant case enumerated the duties to be performed by the parties involved in the multidam construction. Concerned Residents v. Grant, 388 F. Supp. 394, 410 (M.D. Pa. 1975).

6. 537 F.2d at 31. The work plan was submitted to the Agriculture Committees of both houses of Congress in 1961 pursuant to section 2 of the Watershed Act, which requires that, when the amount of federal funding requested for a project is estimated to exceed $250,000, approval by the "appropriate Committees of the Senate and House of Representatives" be obtained. 16 U.S.C. § 1002 (Supp. V 1975). The estimated cost of the proposed project in the instant case was $2 million. 537 F.2d at 31.

7. 537 F.2d at 31.

8. Section 4 of the Watershed Act requires local officials to obtain any easements needed for the project. *See* 16 U.S.C. § 1004(1) (Supp. V 1975). Because the local officials experienced difficulty in obtaining the necessary easements, construction was delayed for approximately nine years. 537 F.2d at 31–32.

supplemental work plans included a cost/benefit analysis[9] which asserted that the benefits of the multidam project, when evaluated as a whole, exceeded its costs.[10] As construction of two of the dams was nearing completion,[11] the plan for the remaining dam, Pa–466, met the opposition of local residents, who claimed that its construction would decrease their property values and interfere with their enjoyment of the area.[12] Seeking declaratory and injunctive relief,[13] the residents instituted a class action,[14] alleging that the SCS decision to award a contract to construct dam Pa–466 violated the Watershed Act[15] since the benefits of that dam, when separately evaluated, did not exceed its costs.[16] The United States District Court for the Middle District of Pennsylvania held that, under the Watershed Act, each dam in a multidam project must be individually cost justified; and, because the benefits of dam Pa–466 did not exceed its costs when separately evaluated, an injunction was issued to restrain its construction.[17] On appeal by the SCS,[18] the United States Court of Appeals for the Third Circuit reversed,[19] *holding* that, under the Watershed Act, a multidam project may

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9. 537 F.2d at 31–32. Section 5 of the Watershed Act provides that a cost/benefit ratio must be determined for any flood control project for which federal assistance is sought: "At such time as the Secretary [of Agriculture] and the interested local organizations have agreed on a plan for works of improvement, *and the Secretary has determined that the benefits exceed the costs* . . . , the local organization may secure . . . services . . . in connection with such works of improvement . . . ." 16 U.S.C. § 1005(1) (1970) (emphasis added). For a discussion of how a cost/benefit ratio is computed, *see* text accompanying note 24 *infra*.

10. 537 F.2d at 31–32. The ratio of benefits to costs in the original work plan was 1.2 to 1, while the supplemental work plan contained an updated ratio of 1.8 to 1. *Id.*

11. *Id.* The original work plan had provided for the construction of four dams. *See* text accompanying note 3 *supra*. However, the conveyance of the necessary easements was conditioned upon deletion of one of the proposed dams from the project. 537 F.2d at 31–32; *see* note 8 *supra*.

12. Supplemental Brief for Appellees at 4.

13. 388 F. Supp. at 396–97. Plaintiffs sought to have construction of dam Pa–466 enjoined, and they further requested that the actions of the SCS be declared violative of section 5 of the Watershed Act, 16 U.S.C. § 1005(1) (1970), and of section 102 of the National Environmental Policy Act (NEPA) 42 U.S.C. § 4332(2)(C) (1970). 388 F. Supp. at 396–96; *see* note 29 and accompanying text *infra*.

14. 388 F. Supp. at 400. Members of the class were local residents "who both use and enjoy [the area's] environmental resources, including its extraordinary fishing, wildlife and scenic beauty." Supplemental Brief for Appellees at 2. The residents alleged that the dam would destroy the recreational aspects of the area "without commensurate benefit in terms of flood protection." *Id.; see* note 48 and accompanying text *infra*.

15. 388 F. Supp. at 396.

16. Brief for Appellees at 10, 24–25.

17. 388 F. Supp. at 399. The district court also held: 1) that the SCS had violated section 102 of NEPA, 42 U.S.C. § 4332(2)(C) (1970), by its failure to file an environmental impact statement (*see* note 29 and accompanying text *infra*); 2) that judicial review of the SCS's actions under the Watershed Act was available; and 3) that the discount rate of 3.25% used by the SCS to convert future dollars into present values was unlawfully low (*see* note 24 and accompanying text & note 34 *infra*). 388 F. Supp. at 398–99.

18. The substantive appeal dealt solely with the issue concerning the Watershed Act, since the SCS did not appeal the district court's determination that it had violated section 102 of NEPA, 42 U.S.C. § 4332(2)(C) (1970). 537 F.2d at 31.

19. Judge Van Dusen, who wrote the opinion, was joined by Judges Adams and Weis.

be treated as a single unit for purposes of computing a cost/benefit ratio. *Concerned Residents v. Grant,* 537 F.2d 29 (3d Cir. 1976).

In response to a growing need to both preserve the nation's resources[20] and protect against loss of life and damage to property,[21] the Watershed Act was enacted in 1954 to provide federal assistance for communities seeking to institute works of improvement in the area of flood control.[22] In order to obtain financial assistance under the Watershed Act, section 5 requires that the benefits of the proposed project exceed its costs.[23] Determination of a cost/benefit ratio involves a complex four step process: 1) defining the benefits and costs of the particular project; 2) assigning monetary values to each benefit and costs; 3) discounting these monetary values to present

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20. Prior to the passage of the Watershed Act, President Eisenhower summarized the federal government's role in the area of resource preservation in an address to Congress:

> The Federal Government has a responsibility to manage wisely . . . public lands and forests . . . . Important values exist in these lands for forest and mineral products, grazing, fish and wildlife, and for recreation. Moreover, it is imperative to the welfare of thousands of communities and millions of acres of irrigated land that such lands be managed to protect the water supply and water quality which comes from them. In the utilization of these lands, the people are entitled to expect that their timber, minerals, streams and water supply, wildlife, and recreational values should be safeguarded, improved, and made available not only for this but for future generations. At the same time, public lands should be made available for their best use under conditions that promote stability for communities and individuals and encourage full development of the resources involved.

President's Message to Congress Relative to a Program Designed to Conserve and Improve the Nation's Natural Resources, H.R. Doc. No. 221, 83d Cong., 1st Sess. (1954), *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 2901–02.

21. The preamble of the Watershed Act provides:

> Erosion, floodwater, and sediment damages in the watersheds of the rivers and streams of the United States, *causing loss of life and damage to property,* constitute a menace to the national welfare; and it is the sense of Congress that the Federal Government should cooperate with States and their political subdivisions, soil or water conservation districts, flood prevention or control districts, and other local public agencies for the purpose of preventing such damages, of furthering the conservation, development, utilization, and disposal of water, and the conservation and utilization of land and thereby of *preserving, protecting, and improving the Nation's land and water resources and the quality of the environment.*

16 U.S.C. § 1001 (Supp. V 1975) (emphasis added)

22. A letter from E.T. Benson, former Secretary of Agriculture, to Clifford R. Hope, then Chairman of the House Committee on Agriculture, described the purpose of the house bill, that was subsequently enacted into law as the Watershed Act: "The dominant purpose of watershed plans provided for by the bill would be flood prevention and water management. . . . The bill provides for cooperative effort by States and local agencies and the Federal Government in a unified manner for . . . the management of water within small watersheds." Letter from E.T. Benson to Clifford R. Hope (Aug. 5, 1953), *reprinted in* S. REP. No. 1620, 83 Cong., 2d Sess. 7 (1954).

23. *See* 16 U.S.C. § 1005(1) (1970). For the pertinent text of subsection, *see* note 9 *supra.*

dollar figures; and 4) converting present value figures into a ratio.[24] Where a large project is composed of several smaller projects, calculation of the overall cost/benefit ratio may be further complicated if each subproject must be separately evaluated to determine whether its benefits exceed its costs.

The Watershed Act is silent as to whether component parts of a large flood control project may be treated as single units in determining the cost/benefit ratio. Section 2 does provide, however, that "[a] number of . . . subwatersheds, when they are component parts of a larger watershed, may be *planned together* when the local sponsoring organizations so desire."[25] While no cases decided under the Watershed Act have clarified this provision, several cases decided under the National Environmental Policy Act of 1969 (NEPA)[26] have addressed a similar issue.[27] In keeping with its purpose of ensuring that environmental factors receive due consideration in the planning of federal programs,[28] NEPA requires that any federal agency seeking to implement a plan that may substantially effect the environment submit an environmental impact statement setting forth the advantages

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24. Note, *Cost-Benefit Analysis in the Courts: Judicial Review Under NEPA*, 9 GA. L. REV. 417, 420–21 (1975). For further discussion of the cost/benefit analysis, *see* Comment, *Judicial Review of Cost-Benefit Analysis Under NEPA*, 53 NEB. L. REV. 540, 545–47 (1974).

25. 16 U.S.C. § 1002 (1970 & Supp. V 1975) (emphasis added).

26. 42 U.S.C. §§ 4321–4347 (1970 & Supp. V 1975).

27. *See* note 30 & 31 and accompanying text *infra*.

28. Section 101 of NEPA provides in part:

> (a) The Congress . . . declares that it is the continuing policy of the Federal Government . . . to use all practicable means and measures . . . to create and maintain conditions under which man and nature can exist in *productive harmony*, and fulfill the social, economic, and other requirements of present and future generations of Americans.
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> (b) In order to carry out the policy set forth in this chapter, it is the continuing responsibility of the Federal Government to use all practicable means, consistent with other essential considerations of national policy, to *improve and coordinate Federal plans*, functions, programs, and resources to the end that the Nation may—
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> . . . .
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> (2) assure for all Americans safe, healthful, productive, and esthetically and culturally pleasing surroundings;
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> (3) attain the widest range of beneficial uses of the environment without degradation, risk to health or safety, or other undesirable and unintended consequences;
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> (4) preserve important historic, cultural, and natural aspects of our national heritage . . . ;
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> . . . .
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> (6) enhance the quality of renewable resources . . . .

42 U.S.C. § 4331(a), (b)(2), (3), (4), (6) (1970) (emphasis added). In addition, section 102(2)(B) states: "the Congress authorizes and directs that, to the fullest extent possible . . . all agencies of the Federal Government shall . . . identify and develop methods and procedures . . . which will insure that presently unquantified environmental amenities and values may be given appropriate consideration in decisionmaking along with economic and technical considerations." *Id.* § 4332(2)(B).

and disadvantages of the proposed project as it relates to the environment.[29] In examining cases brought for violations of NEPA, courts generally have held that, where a project is composed of several subprojects, an environmental impact statement should be filed for the project as a whole,[30] because separate evaluations of project subparts often do not reveal the cumulative detrimental effects which the entire project may have upon the environment.[31] On the other hand, where a separate evaluation of each subproject would reveal more extensive environmental damage than is shown by a comprehensive statement, NEPA's policies seemingly require separate impact statements, for each segment, in order that there be full discovery of, and weight accorded to, the actual environmental costs of the project.[32]

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29. *Id.* § 4332(2)(C). Section 102(2)(C) states that all federal agencies shall include in every recommendation or report on proposals for legislation and other major federal actions significantly affecting the quality of the human environment, a detailed statement by the responsible official on—

(i) the environmental impact of the proposed action,

(ii) any adverse environmental effects which cannot be avoided should the proposal be implemented,

(iii) alternatives to the proposed action,

(iv) the relationship between local short-term uses of man's environment and the maintenance and enhancement of long-term productivity, and

(v) any irreversible and irretrievable committments of resources which would be involved in the proposed action should it be implemented.

Id.

30. *See, e.g.*, Swain v. Brinegar, 9 ENVIR. REP. (BNA) 1086, 89 (7th Cir. July 20, 1975); Sierra Club v. Morton, 514 F.2d 856, 877 (D.C. Cir. 1975); Appalachian Mountain Club v. Brinegar, 394 F. Supp. 105, 115 (D.N.H. 1975); Chelsea Neighborhood Ass'n v. United States Postal Serv., 389 F. Supp. 1171, 1181 (S.D.N.Y. 1975); Thompson v. Fugate, 347 F. Supp. 120, 124 (E.D. Va. 1972). *See also* Kleppe v. Sierra Club, 96 S. Ct. 2718, 2730–31 (1976); Oklahoma *ex rel.* Phillips v. Guy F. Atkinson Co., 313 U.S. 508, 527–28 (1941).

31. As one court reasoned: "One more factory polluting air and water . . . may represent the straw that breaks the back of the environmental camel. Hence the absolute, as well as comparative, effects of a major federal action must be considered." Hanly v. Kleindienst, 471 F.2d 823, 831 (2d Cir. 1972), *cert. denied*, 412 U.S. 908 (1973) (in deciding whether agency action significantly affects the environment, the agency should examine its project in relation to existing environmental conditions).

The concept of the division of a project into subparts for evaluation of its environmental impact is termed "segmentation". *See* Appalachian Mountain Club v. Brinegar, 394 F. Supp. 105, 114–15 (D.N.H. 1975). The rationale against segmenting projects for environmental impact evaluation is founded upon the principle that, in considering the advantages or disadvantages of a particular project, isolated glimpses of particular results may not give a comprehensive objective view of the situation. *Cf.* Louisville & N.R.R. v. Barker Asphalt Paving Co., 197 U.S. 430, 435 (1905). The Third Circuit's opinion in *Concerned Residents* is perhaps subject to criticism for the lack of reference to the term "segmentation" and the NEPA cases which discuss it, although it is possible that the issue was simply never discussed by the parties.

32. The author is aware of no reported situations prior to the present one where separate evaluations of the segments of a project proved to reveal a greater amount of environmental detriment than did the evaluation of the project as a whole. *See* note 45 *infra*. However, where separate evaluations may prove to be more revealing than one cumulative impact statement, it is reasonable to expect a court to find segmentation to be proper, in accordance with NEPA's mandate to federal agencies that they properly and fully account for the environmental effects of their projects. *See* notes 28–31 and accompanying text *supra*.

Before addressing the merits of the action, the Third Circuit extensively considered the questions of standing[33] and judicial review.[34] Finding neither of these issues preclusive, the court confronted the merits of the case, emphasizing initially that nothing in the Watershed Act itself requires that

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33. 537 F.2d at 33. Although the parties had stipulated to standing, the court requested during oral argument that both parties submit supplemental briefs on the issue. *Id.* at 33 n.7. The Third Circuit initially observed that section 10(a) of the Administrative Procedure Act (APA), 5 U.S.C. § 702 (1970), was applicable. 537 F.2d at 33 n.7. Section 10(a) provides: "A person suffering legal wrong because of agency action, or adversely affected or aggrieved by agency within the meaning of a relevant statute, is entitled to judicial review thereof." 5 U.S.C. § 702 (1970). The court noted that *Data Processing Serv. Org., Inc. v. Camp* has interpreted section 10(a) of the APA to mean that an individual has standing to sue under a particular statute if he alleges: 1) that he has sustained or will sustain some actual or threatened injury; and 2) that the injury is one within the "zone of interests" to be protected by the particular statute. 537 F.2d at 33, *citing* Data Processing Serv. Org., Inc. v. Camp, 397 U.S. 150, 152–53 (1970). The court determined that the plaintiffs' allegation in the instant case that the dam would decrease their property values and "impair [their] enjoyment of the area's recreational and aesthetic resources" clearly satisfied the first requirement of injury. 537 F.2d at 33. The Third Circuit then observed that the second standing requirement did not limit the focus solely to the cost/benefit aspect of the Watershed Act, but rather upon the purposes of the Watershed Act as a whole: to "benefit the residents of areas afflicted by flood dangers." *Id.* at 33, *citing* Davis v. Romney, 490 F.2d 1360, 1365 (3d Cir. 1974).

34. The court began its discussion of judicial review by noting the applicability of section 10(e) of the APA, which provides that "[t]he reviewing court shall . . . hold unlawful and set aside agency action, findings, and conclusions found to be arbitrary, capricious, [or] an abuse of discretion." 5 U.S.C. § 706(2)(A) (1970). Section 10 of the APA provides for judicial review "except to the extent that (1) statutes preclude judicial review; or (2) agency action is committed to agency discretion by law." *Id.* § 701. The court pointed out that, in *Citizens to Preserve Overton Park, Inc. v. Volpe,* an action reviewing the Secretary of Transportation's approval of a highway through a park, the Supreme Court interpreted the latter exception very narrowly saying:

> [T]he Secretary's decision here does not fall within the exception for action "committed to agency discretion." This is a very narrow exception. . . . The legislative history of the Administrative Procedure Act indicates that it is applicable in those rare instances where "statutes are drawn in such broad terms that in a given case there is no law to apply."

401 U.S. at 410 (footnotes and citations omitted); *see* Barlow v. Collins, 397 U.S. 159, 174–75 (1970); Ass'n of Data Processing Serv. Org., Inc. v. Camp, 397 U.S. 150, 157 (1970); Abbott Laboratories v. Gardner, 387 U.S. 136, 142 (1967); Sierra Club v. Callaway, 499 F.2d 982 (5th Cir. 1974); Montgomery v. Ellis, 364 F. Supp. 517 (N.D. Ala. 1973).

The *Concerned Residents* court then stated that, since the SCS had asserted that the instant case fell within one of the exceptions to the general rule of availability of judicial review under section 10 of the APA, the SCS had the burden of proving that the legislature intended that projects instituted under the Watershed Act be free from judicial review. 537 F.2d at 34. The court rejected the SCS's contention that the requirement under the Watershed Act of congressional committee approval of large projects implicitly showed that the legislature intended to preclude judicial review under the Watershed Act. *Id.* In the court's view, the purpose of the requirement was not to preclude judicial review, but rather to improve budget control. *Id.* In support of its interpretation, the court stated that, had the legislative purpose of committee approval been to prevent judicial interference, the Congress would have required that the agency submit to the committees a written economic analysis. *Id.* The court noted that its view was further supported by the fact that the approval requirement applied only to large projects. *Id.; see* Letter from Rowland Hughes to

each dam in a multidam project have its own favorable cost/benefit ratio.[35] The court observed that section 5 of the Watershed Act requires only that the "benefits of every 'plan' exceed the costs associated with implementing the plan, not that every segment of the plan be cost justified when viewed in isolation."[36] Furthermore, the court noted that section 2 of the Watershed Act permits the component parts of a single watershed to be planned together.[37]

Perhaps the most important factor in the court's eventual holding, however, was its interpretation of the SCS's own project evaluation manuals: the *Watershed Protection Handbook (Handbook)*[38] and the *Economics Guide for Water Protection and Flood Prevention (Guide).*[39] In response to the plaintiffs' argument that the *Guide* called for the maximization of net benefits,[40] and thus required that each of the dams

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Clifford R. Hope (Aug. 31, 1953), *reprinted in* S. REP. NO. 1620, 83d Cong., 2d Sess. 8–9 (1954), which lends further credence to the Third Circuit's interpretation.

As a result, the court determined that the SCS had not met its burden and that judicial review was therefore proper. 537 F.2d at 34.

It was also held that the SCS's choice of discount rates under section 80 of the Water Resources Development Act of 1974, 42 U.S.C. § 1962d–17 (Supp. V 1975), was subject to judicial review. 537 F.2d at 35. Section 80 permits the use of the 3.25% discount rate used by the SCS in the instant case only if "the appropriate non-Federal interests have, prior to December 31, 1969, given satisfactory assurances to pay the required non-Federal share of project costs." 42 U.S.C. § 1962d–17(b) (Supp. V 1975). In holding that the administrative discretion embodied in the Watershed Act was "not wholly without judicially discernible limits," 537 F.2d at 35, the court rejected the SCS's contention that "the Secretary's discretion . . . is so great that the determination of whether any 'assurances' are 'satisfactory' has been 'committed to agency discretion by law' and hence is unreviewable." *Id., quoting* 42 U.S.C. § 1962d–17(b) (Supp. V 1975), *and* 5 U.S.C. § 701(a)(2) (1970).

35. 537 F.2d at 36.

36. *Id.*

37. *Id., citing* 16 U.S.C. § 1002(2) (1970 & Supp. V 1975). For the relevant portion of section 2 *see* text accompanying note 25 *supra.*

38. SOIL CONSERVATION SERV., U.S. DEP'T OF AGRICULTURE, WATERSHED PROTECTION HANDBOOK (1957) [hereinafter cited as HANDBOOK]. The court examined the following project evaluation procedure delineated in the *Handbook:*

"1. Reach agreement with sponsoring local organization on a minimum level of protection to solve the flood problems of the entire watershed community."

"2. For each hydrologic unit having an essentially separate flood plain, develop the least costly system . . . of protection. . . ."

"3. Evaluate the benefits that will accrue to each system."

537 F.2d at 36, *quoting* HANDBOOK, *supra* at § 105–0222.

39. SOIL CONSERVATION SERV., U.S. DEP'T OF AGRICULTURE, ECONOMICS GUIDE FOR WATER PROTECTION AND FLOOD PREVENTION (1964) [hereinafter cited as GUIDE]. The court reviewed the following provision: " 'In project formulation consideration needs to be given to the interrelationship of structures. Such an interrelationship exists where a group of structures protect a common flood plain. Here the most economical system for attaining the agreed upon level of protection may be evaluated as a unit.' " 537 F.2d at 36–37 *quoting* GUIDE, *supra* at § II–D.

40. 537 F.2d at 37. The principle of maximization of net benefits was described in the *Guide* in the following manner: "From an economic viewpoint, the optimum scale of project developement is the point at which net benefits are at a maximum. Net benefits are maximized when the benefits added by the last increment of scale or scope of project development are equal to the cost of adding that increment." GUIDE, *supra* note 39, at § II–C.

have a favorable cost/benefit ratio when evaluated separately,[41] the Third Circuit pointed out that such an interpretation was inconsistent with other parts of the *Guide* permitting "single evaluations of groups of measures."[42] Moreover, the court reasoned that, since the SCS, the author of the *Guide* and *Handbook*, used the manuals on a regular basis,[43] its interpretations of their provisions should be respected unless unreasonable.[44] For these reasons, the Third Circuit concluded that each dam in a multidam project need not have a favorable cost/benefit ratio;[45] rather, the instant multidam project could be treated as a single unit in determining whether its benefits exceeded its costs.[46]

Although the pertinent sections of the Watershed Act and its *Guide* and *Handbook* were scrutinized carefully, the scope of the Third Circuit's analysis is somewhat disappointing from an environmental standpoint in

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41. 537 F.2d at 37. Plaintiffs reasoned that, if a single dam in a multidam project failed to have a favorable cost/benefit ratio, the ratio of the project as a whole would become less favorable, thereby violating the principle of the maximization of net benefits. *Id.*

42. *Id.* For the text of the relevant portions of the *Guide* and *Handbook*, *see* notes 38–40 *supra*. The court further stated that

> under plaintiffs' interpretation, SCS might be required to reduce the desired level of protection whenever it became apparent that reaching the desired level would involve construction of a cost-inefficient dam. But nothing in the Guide suggests that the principle of maximizing net benefits invariably takes precedent over the goal of attaining agreed upon levels of protection.

537 F.2d at 37–38.

The court also observed that the SCS would permit an exception to the principle of maximizing net benefits "where the dams are interrelated in the sense that they protect a common flood plain," and that the *Guide* itself specifically "permit [ted] an exception to the maximization principle where intangible benefits, incapable of monetary evaluation, [were] associated with the project." *Id.* at 38, *citing* GUIDE, *supra* note 39, at § I–C–2.

43. 537 F.2d at 38.

44. *Id.* The Third Circuit stated: " 'An agency's explication of its regulations if reasonable . . . is controlling despite the existence of other interpretations that may seem even more reasonable.' " *Id.*, *quoting* Lucas Coal Co. v. Interior Bd. of Mine Operations, 522 F.2d 581, 584 (3d Cir. 1975). However, the court added that the *Guide* and *Handbook* did not have the effect of law as they were "merely internal operating procedures, rather than regulations officially promulgated." 537 F.2d at 38.

45. *Id.* at 38–39. It is interesting to note at this point the unusual posture of the parties in *Concerned Residents*. Often, the overall environmental effect of a project is detrimental, and it is the agency which seeks to cost-justify its programs on a segment-by-segment basis while the residents prefer to have the project viewed as a whole. *See* Sierra Club v. Morton, 514 F.2d 856 (D.C. Cir. 1975); Appalachian Mountain Club v. Brinegar, 394 F. Supp. 105 (D.N.H. 1975); Chelsea Neighborhood Ass'n v. United States Postal Serv., 389 F. Supp. 1171 (S.D.N.Y. 1975); Thompson v. Fugate, 347 F. Supp. 120 (E.D. Va. 1972). This typical posture arises from the agency's desire to minimize the appearance of the detrimental effects of those projects which have met the opposition of local residents, who want to emphasize these harmful aspects. However, in *Concerned Residents*, because the overall environmental effect of the multidam project was beneficial, the agency preferred to cost-justify the project in its entirety, particularly in light of the fact that if each dam was separately cost justified, dam Pa–466 probably could not be constructed. *See* note 49 and accompanying text *infra*.

46. 537 F.2d at 38. Referring to section 10(e) of the APA, the court stated that the SCS's decision to treat the dams as a unit was not so arbitrary and capricious that the reviewing court would be compelled to set aside the determination. *Id.*, *citing* 5 U.S.C. § 706(2)(A) (1970). For the text of this subsection *see* note 34 *supra*.

that there was no attempt by the court to coordinate its decision with the policies of resource preservation around which the Watershed Act and NEPA revolve.[47] A discussion of such policies would have been particularly appropriate in the instant case, in light of the fact that construction of the dam in question was likely to destroy a substantial portion of the ecology of Buck Hill Creek. In the district court's opinion of the *Concerned Residents* case, it was recognized that dam Pa-466, if built, would likely have a detrimental effect upon this extremely popular trout-fishing stream by increasing the water temperature to intolerable levels for trout, by preventing migration, and by altering flow patterns, which would drastically affect fish habits.[48]

A decision that the Watershed Act requires separate cost/benefit ratios for each dam would have prevented construction of dam Pa-466 and the injury to the environment which the dam might have caused, since the benefits of *that particular dam* did not exceed its costs.[49] However, the Third Circuit's decision to permit the multidam project to be treated as a single unit for purposes of determining the cost/benefit ratio is likely to result in the construction of the dam in question, with its potentially harmful attendant environmental effects, because the benefits of the project, *when viewed in its entirety,* did in fact exceed the project's costs.[50] The purposes behind the Watershed Act are clearly contrary to such a result.[51] The Act's declaration of policy clearly states that "preserving, protecting, and improving the Nation's land and water resources and the quality of the environment" is the goal of its flood control programs.[52] Moreover, in referring to the Watershed Act, President Eisenhower indicated that flood prevention plans were to be submitted to Congress "only if the Secretary is satisfied that such works constitute needed and *harmonious* elements in the comprehensive development . . . involved."[53] Both of these statements suggest that a policy of environmental preservation and harmony should underlie all projects brought under the Watershed Act. Since the court's

47. *See* notes 20-22 & 28-32 and accompanying text *supra.*

48. 388 F. Supp. at 406. The district court explained that the dam, if built, could cause the temperature of the water to rise to at least 71 degrees. *Id.* at 404. Since trout cannot withstand temperatures above 70 to 72 degrees, this anticipated rise in temperature would either destroy the trout immediately or cause them to crowd into areas of tolerable temperatures, which could also result in their elimination. *Id.* at 404-05. The district court further noted that the dam would interfere with the major spawning area by causing silting (a redepositing of tiny, loose, sedimentary particles), which would cut off the oxygen supply to fish eggs deposited in the spawning area. *Id.* at 405.

49. The cost/benefit ratio of the dam would satisfy section 5 of the Watershed Act only if, on remand, the district court reversed its prior decision that the assurances received from the local officials to pay the non-federal costs were unsatisfactory, and therefore that the proper discount rate had been utilized. *See* note 17 *supra.* However, even if the 3.25% discount rate is permitted, the cost/benefit ratio of dam Pa-466 would still only be 1.05 to 1, which is marginal at best. *See* 388 F. Supp. at 399.

50. 537 F.2d at 32; *See* note 10 *supra.*

51. *See* notes 20-22 and accompanying text *supra.*

52. 16 U.S.C. § 1001 (Supp. V 1975). For the text of this section, *see* note 21 *supra.*

53. Exec. Ord. No. 10,584, 3 C.F.R. 232, 233 (1954), *reprinted in* 16 U.S.C. § 1005 (1970) (emphasis added).

decision in the instant case might produce a result contrary to the policy of resource preservation upon which the Watershed Act is founded, a discussion of this policy and an explanation of its relation to the facts of the instant case would have substantially reinforced the court's conclusion.

Furthermore, a second and closely related deficiency in the scope of the Third Circuit's analysis lies in the lack of any discussion of NEPA,[54] its policies, and its application to the *Concerned Residents* case. NEPA attempts to ensure that agencies sponsoring federal programs consider the environmental impact of their proposed projects so that the resources of the nation may be best preserved.[55] The applicability of this federal policy of environmental consideration to projects being funded under the Watershed Act would seem apparent upon examination of NEPA's statutory language. Section 102(1) of NEPA provides that "[t]he Congress authorizes and directs that, to the fullest extent possible, the policies, regulations, *and public laws of the United States shall be interpreted and administered in accordance with the policies set forth in this chapter.*"[56] Furthermore, it has been held that NEPA's application is not to be limited solely to the requirement of the filing of an environmental impact statement,[57] and that violations of NEPA may be found even in situations where an impact statement is not required.[58] It would seem, therefore, that NEPA's intended scope is too broad and pervasive to have been entirely overlooked[59] by the Third Circuit in *Concerned Residents*, and perhaps some consideration of the environmental impact of its decision concerning the multidam project should have been undertaken by the court.

It should be emphasized that a consideration of environmental factors, as is apparently required under both the Watershed Act and NEPA, would not necessarily have compelled the court to reach a different conclusion,

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54. *See* notes 26–31 and accompanying text *supra*.

55. *See* notes 28 & 29 and accompanying text *supra*.

56. 42 U.S.C. § 4332 (1970 & Supp. V 1975) (emphasis added). In addition, section 105 provides that "[t]he policies and goals set forth in this chapter are supplementary to those set forth in existing authorizations of Federal agencies." *Id.* § 4335.

57. Hanly v. Kleindienst, 471 F.2d 823, 834–35 (2d Cir. 1972), *cert. denied*, 412 U.S. 908 (1973) (mandate of section 102(D) of NEPA to develop alternatives to proposed action may apply even to actions which do not significantly effect the environment).

58. Trinity Episcopal School Corp. v. Romney, 523 F.2d 88, 93 (2d Cir. 1975) (section 102(2)(D) of NEPA, which requires the sponsoring agency to develop alternatives to the proposed action, is applicable even in the absence of the filing of an environmental impact statement).

59. Calvert Cliffs' Coordinating Comm., Inc. v. United States Atomic Energy Comm'n, 449 F.2d 1109 (D.C. Cir. 1971), was one of the first cases to consider the broad ramifications of NEPA. In referring to the policy behind NEPA, the *Calvert* court indicated that NEPA "makes environmental protection a part of the mandate of every federal agency and department." *Id.* at 1112. The *Calvert* court further recognized that "[t]he sweep of NEPA is extraordinarily broad, compelling consideration of any and all types of environmental impact of federal action." *Id.* at 1122; *see* Environmental Defense Fund v. Army Corps of Engrs., 470 F.2d 289, 294 (8th Cir. 1972), *cert. denied*, 412 U.S. 931 (1973); Environmental Defense Fund v. Army Corps of Engrs., 348 F. Supp. 916, 927 (N.D. Miss. 1972), *aff'd*, 492 F.2d 1123 (5th Cir. 1974); Thompson v. Fugate, 347 F. Supp. 120, 124 (E.D. Va. 1972); Natural Resources Defense Council, Inc. v. Grant, 341 F. Supp. 356, 367 (E.D.N.C. 1972). *See also* Sierra Club v. Federal Power Comm'n, 407 U.S. 926, 927-28 (1972) (Douglas, J., dissenting).

since it could have been decided that the SCS interpretations of the Watershed Act, the *Guide*, and the *Handbook* were overridingly reasonable.[60] It also should be noted that the environmental impact of the dam in question will be considered at some point before its construction, since the district court has ordered the SCS to file an environmental impact statement.[61] Nevertheless, it is unfortunate that the court did not consider these legislative mandates, since the decision to permit the multidam project to be cost justified as a whole, without examining the impact of such a decision upon the environment may implicitly encourage other courts to similarly overlook environmental considerations. It would seem that if federal environmental priorities are ever to be implemented, their connection with many aspects of statutory interpretation must be fully recognized.

Susan Kassell

MEDICAID — ABORTION — THE MEDICAID ACT REQUIRES A PARTICIPATING STATE TO FUND NONTHERAPEUTIC ABORTIONS IF THE STATE ALSO USES MEDICAID FUNDS TO FINANCE FULL TERM DELIVERIES AND THERAPEUTIC ABORTIONS.

Doe v. Beal (1975)

Plaintiffs were eleven unmarried indigent women,[1] participating in the Pennsylvania Medical Assistance Program[2] (PMAP), whose pregnancies

60. *See* note 44 *supra*. NEPA does not expressly prohibit federal programs which are harmful to the environment. *See* Citizens Organized to Defend Environment, Inc. v. Volpe, 353 F. Supp. 520, 541 (S.D. Ohio 1972). Rather, NEPA merely requires that the environmental effects of decisions concerning federally funded projects be considered. *See* 42 U.S.C. §§ 4331, 4332 (1970 & Supp. V 1975); notes 28–29 and accompanying text *supra*.

61. 388 F. Supp. at 399; *see* note 17 *supra*.

1. The Medicaid statute requires that participating states provide aid to the "categorically needy," 42 U.S.C. § 1396a(a)(10)(A) (1970), including those receiving Aid to Families with Dependent Children (AFDC), *id.* §§ 601–610, and allows the state to provide aid to other "medically needy" persons, *id.* § 1396a(a)(10)(B)-(C), as defined by the state. In Pennsylvania, this includes those receiving Public Assistance, PA. STAT. ANN. tit. 62, §§ 401–435 (Purdon 1952).

The Medicaid statute requires that five services be provided to the categorically needy:1) inpatient hospital services, 2) outpatient hospital services, 3) laboratory and X-ray services, 4) nursing facility, diagnosis of children, and family planning services, and 5) physician's services, 42 U.S.C. § 1396d(a)(1)–(5) (1970). Further, the state must provide 7 of 16 types of listed services for the "medically needy." *Id.* § 1396d(a)(1)–(16).

Of the 11 plaintiffs, 6 were "categorically needy" and 5 were "medically needy." However, Pennsylvania does not discriminate between its categorically and medically needy in providing services. Doe v. Beal, 523 F.2d 611, 619 n.16 (3d Cir. 1975), *cert. granted*, 96 S. Ct. 3220 (1976).

2. Legislation establishing the PMAP may be found at PA. STAT. ANN. tit. 62, §§ 441.1–451 (Purdon 1952).

ranged from six to seventeen weeks.[3] They unsuccessfully attempted to obtain elective, as opposed to therapeutic, abortions[4] from Magee-Womens Hospital in Pittsburgh. The hospital refused solely because such abortions would not be reimbursable under the regulations of the defendant Pennsylvania Department of Public Welfare (Department), which administers the PMAP.[5]

In a suit in the United States District Court for the Western District of Pennsylvania filed against the Department and several of its officers, plaintiffs attacked the Department's regulations on both statutory and constitutional grounds, contending that they were inconsistent with title XIX of the Social Security Act (Medicaid Act)[6] and violative of the equal protection clause of the fourteenth amendment.[7] A three-judge panel found that although the regulations were consistent with the statute,[8] they nonetheless acted to deprive plaintiffs of equal protection of the laws.[9] Therefore the panel entered the requested declaratory judgment.[10] The United States Court of Appeals for the Third Circuit,[11] sitting en banc,[12] invalidated the regulations on statutory grounds, and therefore did not

3. Doe v. Wohlgemuth, 376 F. Supp. 173, 177 (W.D. Pa. 1974).

4. "Elective," as used here, describes abortions that are reimbursable under the regulations established by the Pennsylvania Department of Public Welfare. *See* note 5 *infra*. "Therapeutic" describes abortions reimbursable under the regulations.

5. 523 F.2d at 613–14. The Department's regulations provided that abortions could be performed under the PMAP only when the following conditions are satisfied:

1. There is documented medical evidence that continuance of the pregnancy may threaten the health or life of the mother;
2. There is documented medical evidence that the infant may be born with incapacitating physical deformity or mental deficiency; or
3. There is documented medical evidence that the continuance of a pregnancy resulting from a legally established statutory or forcible rape or incest, may constitute a threat to the mental or physical health of the patient;
4. Two other physicians chosen because of their recognized professional competency have examined the patient and concurred in writing; and
5. The procedure is performed in a hospital accredited by the Joint Commission on Accreditation of Hospitals.

Doe v. Wohlgemuth, 376 F. Supp. 173, 175 (W.D. Pa. 1974).

The plaintiffs advanced the following rationales for their decisions to seek abortions: "because a birth at my age would be a severe burden on my life as well as my family;" "I already have four children and another child would further burden our financial plight and cause severe stress on me;" "I am still in high school and do not wish to have a baby at this time;" "because my two children and myself are already in financial difficulty and a birth at this time would be a severe burden on my emotional state;" and "because of the burden and interruption to my personal life that birth would cause." 376 F. Supp. at 178. A detailed statement of the facts may be found in the district court's opinion. *Id.* at 175–78.

6. 42 U.S.C. §§ 1396–1396i (1970).

7. 523 F.2d at 614. In addition to a declaratory judgment, plaintiffs sought class action status and injunctive relief. Both were denied by the district court, and the denials were not appealed. *Id.* at 613 nn.1 & 2.

8. 376 F. Supp. at 182–86.

9. *Id.* at 186–92; *see* note 22 *infra*.

10. 523 F.2d at 613.

11. Judge Van Dusen wrote the court's opinion. Dissenting opinions were filed by Judges Kalodner and Adams. 523 F.2d at 624, 635. Judge Gibbons joined in all but one section of Judge Kalodner's dissent. *Id.* at 635.

12. Between the three-judge district court's order and the Third Circuit's en banc opinion, the case was argued before a Third Circuit panel; its opinion and judgment

reach the constitutional question. The Third Circuit modified the district court's order and remanded,[13] *holding* that the Medicaid Act requires any state which finances full term delivery and therapeutic abortions to finance nontherapeutic abortions through the end of the second trimester of pregnancy. *Doe v. Beal*, 523 F.2d 611 (3d Cir. 1975), *cert. granted*, 96 S. Ct. 3220 (1976).[14]

The Medicaid Act,[15] like much national social welfare legislation, utilizes a carrot-and-stick approach to achieve its aims: states are encouraged to appropriate money for medical services by the offer of federal matching funds.[16] This approach to social welfare policy has prompted the states to do whatever is necessary to receive matching funds,[17] while utilizing the money received from Washington to implement their own policy goals as much as possible.[18]

The Supreme Court abortion decisions, *Roe v. Wade*[19] and *Doe v. Bolton*,[20] which sharply restricted the authority of the states to regulate abortions,[21] generated the instant statutory controversy regarding the degree of control which a state may exercise, within the Medicaid Act, over the maternal health care servies that it funds. Pregnant Medicaid Act eligibles in several states have successfully attacked state regulations

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were filed on December 10, 1974. On January 31, 1975, the court vacated the panel's judgment and ordered reargument en banc for May 8, 1975. Doe v. Beal, 523 F.2d at 613. The panel's opinion, presumably withdrawn, was not reported.

13. Using their power under 28 U.S.C. § 2106 (1970) to modify a supplemental order of a district court, the Third Circuit merely altered the reasons for giving declaratory judgment for the plaintiffs — citing statutory rather than constitutional grounds. This obviated the need to reconvene a three-judge panel. 523 F.2d at 624.

14. Doe v. Beal was argued before the Supreme Court on October 6, 1976 and January 11, 1977. [1976-1977] U.S. SUPREME COURT BULLETIN (CCH) 8017, 8102.

15. 42 U.S.C. §§ 1396–1396i (1970).

16. *See id.* § 1396b.

17. *See, e.g.*, PA. STAT. ANN. tit. 62, § 451 (Purdon 1952). While state participation in any of the categorical grant programs is nominally voluntary, the effect of federal matching funds, is that no state can afford *not* to participate. All 50 states participate in the AFDC program. Dandridge v. Williams, 397 U.S. 471, 472–73 (1970). All states except Arizona participate in Medicaid. Comment, *Abortion on Demand in a Post-*Wade *Context: Must the State Pay the Bills?*, 41 FORDHAM L. REV. 921, 932–33 n.80 (1973).

18. For examples of "deviant" state policies which have been challenged as inconsistent with the Social Security Act, *see* Van Lare v. Hurley, 421 U.S. 338 (1975); Burns v. Alcala, 420 U.S. 575 (1975); New York Dep't of Social Servs. v. Dublino, 413 U.S. 405 (1973); Jefferson v. Hackney, 406 U.S. 535 (1972); Townsend v. Swank, 404 U.S. 282 (1971); Lewis v. Martin, 397 U.S. 552 (1970); Dandridge v. Williams, 397 U.S. 471 (1970); Rosado v. Wyman, 397 U.S. 397 (1970); King v. Smith, 392 U.S. 309 (1968).

19. 410 U.S. 113 (1973).

20. 410 U.S. 179 (1973).

21. In Roe v. Wade, 410 U.S. 113 (1973), the Court held that a Texas criminal abortion statute, which prohibited abortions except when necessary to save the mother's life, was an unconstitutional denial of due process of law under the fourteenth amendment. In an unusually specific holding, the Court stated that during the first trimester of pregnancy, the states could not in any way regulate the decision of a woman regarding abortion; during the second trimester, the states could pass regulations reasonably related to the protection of maternal health; only in the third trimester of pregnancy, when the state had a compelling interest in protecting the life of a viable human being, could a state prohibit an abortion outright. *Id.* at 163–65. However, the Chief Justice stated: "Plainly the Court today rejects any claim that the

denying funds for nontherapeutic abortions on the ground that they deny equal protection.[22] However, prior to the instant case, only two courts had adjudicated the controversy on statutory grounds, reaching opposite conclusions.[23]

In *Roe v. Norton*,[24] the Commissioner of Welfare of the State of Connecticut interpreted the Medicaid Act to *prohibit* reimbursement for nontherapeutic abortions[25] and adopted a regulation to that effect.[26] The United States District Court for the District of Connecticut held that the act not only did not require, but did not *permit* such a regulation.[27] Although agreeing with the defendant-Commissioner that the statute limited federal reimbursement "to meet the costs of necessary medical and remedial care and services,"[28] the court found elective abortions to be such a service within the meaning of the act.[29] The court stated that even though the plaintiffs'

Constitution requires abortion on demand." *Id.* at 208 (concurring in both *Doe v. Bolton* and *Roe v. Wade*).

In Doe v. Bolton, 410 U.S. 179 (1973), the Court struck down a Georgia abortion statute under which abortion was a crime unless, among other requirements, it was performed by a licensed physician in whose judgment the abortion was necessary because the pregnancy would 1) endanger the woman's life or health, or 2) produce a child with a serious birth defect, or 3) unless the pregnancy resulted from rape or incest. *Id.* at 183–84. These are almost identical to three of the requirements for a therapeutic abortion in the PMAP regulations in controversy. *See* note 4 *supra*. In *Bolton*, the Court affirmed the holding of the district court that these three restrictions on the physician's judgment were unconstitutional invasions of the mother's privacy and liberty, although technically the issue was not before them. 410 U.S. at 186–87. However, the Court also agreed with the district court in upholding the state's right to require that all abortions be approved by a physician as necessary for his patients' physical or mental health, based upon his best clinical judgment, taking all factors into consideration. *Id.* at 191–92.

The Georgia statute, like the PMAP regulations, also required the assent of two other physicians and performance of the operation in an accredited hospital. *Id.* at 184. The Court held that these two requirements would violate the due process clause in *every* instance. *Id.* at 194–200.

22. The theory of the equal protection attack on the regulations is, briefly, that since Roe v. Wade, 410 U.S. 113 (1973), a woman has a fundamental right to an abortion and, as there is no compelling state interest in distinguishing between the funding of therapeutic and nontherapeutic abortions, such classification is unconstitutional. *See* Doe v. Wohlgemuth, 376 F. Supp. 173, 186–91 (W.D. Pa. 1974). The following cases have so held: Wulff v. Singleton, 508 F.2d 1211 (8th Cir. 1975), *rev'd on other grounds*, 96 S. Ct. 2868 (1976); Doe v. Rampton, 366 F. Supp. 189 (D. Utah 1973); Klein v. Nassau County Medical Center, 347 F. Supp. 496 (E.D.N.Y. 1972), *vacated and remanded*, 412 U.S. 925 (1973).

23. In the present case, the district court fully discussed the statutory question before invalidating the regulations on constitutional grounds. It found no inconsistency between the PMAP regulations and the Medicaid Act. *See* 376 F. Supp. at 182–86.

24. 380 F. Supp. 726 (D. Conn. 1974).

25. *Id.* at 727.

26. Connecticut Welfare Dep't, Public Assistance Program Manual, vol. 3, ch. III, § 275 (1973).

27. 380 F. Supp. at 729. The regulation was deemed inconsistent with the following provision of the Medicaid Act: "For the purposes of this subchapter, the term 'medical assistance' means . . . medical care, or any other type of remedial care recognized under State law, furnished by licensed practitioners within the scope of their practice. . . ." 42 U.S.C. § 1396d(a)(6) (1970).

28. 42 U.S.C. § 1396a(a)(10)(C)(i) (1970).

29. 380 F. Supp. at 729.

doctors had certified that the abortions were not necessary for the mothers' health,[30] the question of "whether that circumstance exclude[d] these abortions . . . [was one] of law, not of medicine."[31] Observing that pregnancy is a medical condition that necessitates medical treatment, the court found it best to leave the choice of treatment to the discretion of patient and doctor, so long as the treatment chosen was an accepted and not excessively costly medical procedure.[32]

In sharp contrast to *Norton* was the decision of the Sixth Circuit in *Roe v. Ferguson,*[33] the only appellate case to uphold nontherapeutic abortion regulations on statutory grounds.[34] In *Roe v. Ferguson,* plaintiffs, including pregnant indigents, doctors, and clinics, challenged the validity of an Ohio statute,[35] and the regulations thereunder, which prohibited the use of state funds for any abortion that was not necessary to preserve the life or health of the mother. The district court granted plaintiffs summary judgment on the theory that the Medicaid Act prohibited participating states from distinguishing elective abortion expenses from all other medical expenses.[36] In reversing, the Sixth Circuit noted that the Medicaid Act had been enacted prior to the Supreme Court abortion decisions, and then commented:

> There is no indication that Congress intended to require the furnishing of abortion services not required for the preservation of the health of the woman at a time when the performance of such abortions was illegal in most jurisdictions. In view of the disfavor shown towards abortions in other legislation, we are reluctant to infer that Congress intended to include required coverage for such controversial services without even mentioning the subject.[37]

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30. *Id.*

31. *Id.*

32. *Id.* at 729–30. Here the court seemed to be paraphrasing 42 U.S.C. § 1396d(a)(6) (1970), but did not cite that section.

33. 515 F.2d 279 (6th Cir. 1975).

34. In his dissent in *Doe v. Beal,* Judge Kalodner cited Doe v. Rose, 499 F.2d 1112 (10th Cir. 1974), as a second example, but the learned judge appears to have been mistaken. There the court stated:

> [I]n light of the applicable statutes' complete silence on the abortion question, we prefer to dispose of the present appeal on constitutional grounds, rather than by any strained effort to show that the policy in question is, in effect, though not in so many words, prohibited by either federal or state statute.

Id. at 1115.

35. OHIO REV. CODE ANN. § 5101.55c (Page 1974).

36. 515 F.2d at 279. Specifically, the district court, relying upon 42 U.S.C. § 1396d(a)(1)–(5) (1970), argued that the five services listed in that section (*see* note 1 *supra*), which were mandatory under 42 U.S.C. §1396a(a)(13)(B), (C)(i) (1970), included abortion services. 515 F.2d at 279.

37. 515 F.2d at 283. In support of this statement, the Sixth Circuit noted that abortion was specifically excluded as a means of family planning under the Family Planning Services and Population Research Act of 1970, 42 U.S.C. § 300a(6) (1970). 515 F.2d at 283. Likewise, in establishing the Legal Services Corporation System, Congress provided that no funds could be used to assist those seeking to procure a nontherapeutic abortion. 42 U.S.C. § 2996f(b)(8) (Supp. V 1975).

Similarly, the district court in the instant case, after reviewing the five mandatory services thought crucial in the district court opinion of *Roe v. Ferguson* (*see* notes 1 & 36 *supra*), noted that abortion services were not specifically provided for in the Medicaid Act. 376 F. Supp. at 184. The court viewed the Medicaid Act as a

In *Doe v. Beal*, however, the Third Circuit rejected the Sixth Circuit's emphasis upon congressional intent, stating: "It is impossible to believe that in enacting Title XIX [Medicaid Act] Congress intended to freeze the medical services available to recipients at those which were legal in 1965."[38] Rather, the Third Circuit adopted a line of reasoning parallel to that employed by the *Norton* court,[39] concluding that the statutory mandate that funds be provided only for necessary treatment[40] allows a state latitude to determine what conditions necessitate treatment, but reserves the choice of treatment for a medical condition to the physician and the patient.[41] The court then analyzed Pennsylvania's obligations under the Act as follows: 1) the proper treatment of a medical condition must be left to the judgment of the attending physician under the act;[42] 2) since Pennsylvania funds full term delivery and therapeutic abortions for Medicaid eligibles, the state has determined that pregnancy is a condition necessitating medical treatment;[43] 3) there is no justification for differentiating elective abortions from other treatments of the condition of pregnancy;[44] therefore, 4) a state which finances full term delivery and therapeutic abortions under its Medicaid program cannot decline to fund elective abortions during the first two trimesters of pregnancy[45] if an eligible woman and her physician so

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"scheme of cooperative federalism" under which Congress gave the states great latitude in administering their programs; the statutory language could be said neither to require nor to prohibit the state funding of elective abortions. *Id.* at 184–86. In reaching this conclusion, the district court relied heavily upon New York State Dep't of Social Servs. v. Dublino, 413 U.S. 405 (1973), Jefferson v. Hackney, 406 U.S. 535 (1972), and Dandridge v. Williams, 397 U.S. 471 (1970), and quoted the latter opinion extensively. *See* 376 F. Supp. at 184–85.

38. 523 F.2d at 622–23.

39. *See* text accompanying notes 24–32 *supra*.

40. *See* 42 U.S.C. §§ 1396, 1396a(a)(10)(C)(i), 1396a(a)(30) (1970). The defendants in *Norton* had also relied upon that provision of the Medicare Act adopted at the same time as Medicaid, which disallowed reimbursement for any expenses incurred "which are not reasonable and necessary for the diagnosis or treatment of illness or injury . . .," 42 U.S.C. at § 1395y(a)(1) (1970). 380 F. Supp. at 729. The *Norton* court admitted that legislative history supported a common interpretation for both acts, as "it is not likely that Congress intended to provide broader benefits to the indigent than to those who were purchasing coverage under Medicare." *Id.*

41. 523 F.2d at 618, 620. As other examples of the limits upon state discretion in the Medicaid Act, the court cited the mandatory nature of services (*see* note 1 *supra*) and certain equality of distribution requirements, 42 U.S.C. § 1396a(10) (1970). 523 F.2d at 617.

42. 523 F.2d at 620. In support of this, the court relied upon *Roe v. Wade* and 42 U.S.C. § 1396d(a)(6) (1970), for the proposition that the statute mandated the funding of all physician services licensed by the state, which, since *Wade* and *Bolton*, included abortion services. A similar conclusion was reached in Comment, *Abortion on Demand in a Post-*Wade *Context: Must the State Pay the Bills?*, 41 FORDHAM L. REV. 921, 934 (1973).

43. 523 F.2d at 621.

44. *Id.* at 621–22. All parties to the controversy admitted that elective abortions are usually cheaper than either therapeutic abortions or full term deliveries coupled with prenatal and postnatal care, and that elective abortions, at least in the first trimester of pregnancy, are the safest method of treatment for the mother. Thus, neither economy nor maternal health could be advanced as a justification for Pennsylvania's regulations.

45. *Id.* at 622. The court cited *Roe v. Wade* and *Doe v. Bolton* as controlling, with the caveat that, consistent with those opinions, Pennsylvania could require

decide.[46] Thus, finding the regulations of the Department prohibiting reimbursement for elective abortions invalid as inconsistent with the Medicaid Act, the Third Circuit instructed the district court to issue a declaratory judgment to that effect.[47]

It is respectfully submitted that the majority erred on this issue.[48] The language of the Medicaid Act can hardly justify the court's holding that a participating state which funds therapeutic abortions and full term deliveries is *required* to fund elective abortions. The word "abortion" does not appear in the statute. While all parties to the case admitted that the statute mandated only "necessary treatment,"[49] the Third Circuit defined "necessary treatment" to mean *any* treatment prescribed by a physician for a condition designated as requiring medical care. A more logical interpretation of "necessary treatment" would have excluded plaintiffs' elective abortions.[50] By definition, a nontherapeutic abortion is not performed in

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reimbursed abortions to be performed in a hospital during the second trimester since, in that trimester, the medical risk to the mother from abortion is significant. *Id.* at 622 n.25.

46. *Id.* at 622.

47. *Id.* at 623–24. By so interpreting the Medicaid statute, the Third Circuit placed *Doe v. Beal* within the *King v. Smith,* as opposed to the *Dandridge v. Williams,* line of cases which have determined the degree of state latitude permissible under the Social Security Act.

King v. Smith, 392 U.S. 309 (1968), had struck down the Alabama "substitute father" rule prohibiting AFDC payments to otherwise eligible families where the mother cohabited with an able-bodied man. The Court discerned that when Congress had provided for payments to children without a "parent" in the AFDC legislation, 42 U.S.C. § 606(a) (1970), it must have meant children without someone who had a legal duty to support them. Thus, "parent" would not have included an Alabama "substitute father." The Court, therefore, held that the Alabama rule improperly denied benefits to persons declared eligible by Congress. 392 U.S. at 333.

In the *King* line, *see* Van Lare v. Hurley, 421 U.S. 338 (1975) (modified "substitute father" rule); Carleson v. Remillard, 406 U.S. 398 (1972) (father serving in armed forces held to be "continually absent" from home); Townsend v. Swank, 404 U.S. 282 (1971) (aid must be given to needy 18-20 year olds in college); Lewis v. Martin, 397 U.S. 552 (1970) (yet another unsuccessfully modified "substitute father" rule).

In Dandridge v. Williams, 397 U.S. 471 (1970), the state of Maryland had imposed a maximum limit of $250 on the AFDC funds which a family unit could receive in a month. Plaintiffs, all with families whose computed standard of need would have otherwise exceeded the maximum payment, contended that younger children in eligible large, needy families were being wholly denied mandatory benefits. However, the Court, characterizing the scheme as a per capita diminution of the family grant, upheld the power of the states to so decrease the level of benefits paid to the eligibles "[s]o long as some aid is provided to all eligible families and all eligible children, the statute itself is not violated." *Id.* at 481. In the *Dandridge* line, *see* Burns v. Alcala, 420 U.S. 575, (1975); New York Dep't of Social Servs. v. Dublino, 413 U.S. 405 (1973); Jefferson v. Hackney, 406 U.S. 535 (1972).

48. For an opposite view, in agreement with the majority, *see* Comment, *supra* note 42, at 937–38. The majority's view has recently been repudiated by the Supreme Court.

49. *See* note 40 *supra.*

50. No doubt plaintiffs in our case would characterize their desired abortions as "necessary," in the sense that childbirth would be a financial hardship or personal inconvenience to them (*see* note 3 *supra*), but this should be distinguished from "necessary" in the medical sense. For a discussion of the requirement that treatment be medically necessary, *see* note 40 *supra.*

response to the mother's ill health.[51] On the other hand, medical assistance is unquestionably necessary in performing either a therapeutic abortion or full term delivery to protect the health of the mother, and in the latter case, the child.

Rather than straining to find an implied bar to the Department's regulations in the language of the statute, the majority should have interpreted the statute in light of administrative and congressional intent. As pointed out by Judge Kalodner in his dissent, the majority's interpretation of the Medicaid Act ignored the opinions of both the Solicitor General[52] and the Department of Health, Education and Welfare,[53] who viewed the statute as neither prohibiting nor requiring participating states to fund elective abortions. The court thereby violated "the settled rule that construction of a statute by an agency charged with its administration should be accorded great deference, absent compelling indications that it is clearly wrong."[54] Similarly, the court's assertion that Congress could not have intended to freeze medical services at those legal in 1965 does not prove that Congress would have required the states to fund elective abortions in their Medicaid programs if they had then been legal. In fact, since *Roe v. Wade,* Congress has evidenced nothing but hostility toward the use of national funds for nontherapeutic abortions.[55]

The Third Circuit should have adopted the lower court's reasoning that, since the statute does not specifically prohibit, require, or otherwise mention abortions, the funding of elective abortions for Medicaid eligibles should be a matter of state discretion.[56] Had it adopted this position, the court would have been forced to determine the constitutionality of the PMAP regulations

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51. *See* STEDMAN'S MEDICAL DICTIONARY 1435 (4th ed. 1976). Within the definition of the word "therapeutic," an opposite result can logically be argued, but only if one defines pregnancy as a "disease." *See id.*

52. 523 F.2d at 625, 629 (Kalodner, J., dissenting), *citing* the Memorandum Amicus Curiae of the Solicitor General filed in Nassau County Medical Center v. Klein, 412 U.S. 95 (1973) (vacated and remanded in light of *Roe v. Wade*).

53. 523 F.2d at 625, *citing* 1 MEDICARE & MEDICAID GUIDE (CCH) ¶ 14,511.

54. 523 F.2d at 630 (Kalodner J., dissenting). The dissent cited the following cases in support of its view: Lewis v. Martin, 397 U.S. 552, 559 (1970); Rosado v. Wyman, 397 U.S. 397, 415 (1970); Federal Hous. Administration v. Darlington, Inc., 358 U.S. 84, 90 (1958); Bernstein v. Ribicoff, 299 F.2d 248, 253 (3d Cir. 1962).

55. *See* note 30 *supra.* In fact, subsequent to the Third Circuit's decision in *Doe v. Beal,* Congress passed a bill prohibiting the use of federal funds for nontherapeutic abortions. However, the statute was declared unconstitutional by a district court judge in Buckley v. McCrae, Nos. 76–C–1804 and 76–C–1805 (E.D.N.Y. Oct. 22, 1976). The Supreme Court on November 8, 1976, denied an application for a stay of the order enjoining the enforcement of the statute pending appeal. [1976-1977] U.S. SUPREME COURT BULLETIN (CCH)B–188.

56. In fact, that Congress intended to provide the states at least some latitude in selecting which kinds of services it would provide is evidenced by the Medicaid Act itself, which allows a state to choose any 7 of 16 types of medical services to be provided for medically needy eligibles. *See* 42 U.S.C. § 1396a(a)(13)(C)(ii), 1396d(1)–(16) (1970).

It is in this respect that the majority's reliance on *King v. Smith* (*see* note 47 *supra*) is misplaced. The principle of law derived from *King* and its progeny is that the state cannot wholly deny benefits to individuals who are eligible for assistance under congressional standards. In this case the indigent plaintiffs have not been denied *all* Medicaid benefits, they have only been denied reimbursement for elective abortions.

under the equal protection clause.[57] Although invalidating state action on statutory grounds is preferable to deciding a constitutional issue unnecessarily,[58] it is not always possible. A remedy may well have been appropriate in the instant case, but if so, the Third Circuit's strained interpretation of the Medicaid Act was not the proper vehicle for achieving it.

J. Kurt Straub

ANTITRUST LAW — PRICE FIXING AND PRODUCT RESTRICTIONS IN AGREEMENT BETWEEN LICENSOR AND LICENSEE HELD NOT VIOLATIVE OF SECTION 1 OF THE SHERMAN ACT.

Evans v. S.S. Kresge Co. (1976)

From 1964 to 1969, Hempfield Stores, Inc. (Hempfield), pursuant to an agreement with S.S. Kresge Co. (Kresge), operated two food stores adjacent to and in the same building with Kresge department stores operated under the trade name "K-Mart."[1] The salient terms of the licensing agreement, which permitted Hempfield to use the name "K-Mart Foods" at each store, required Hempfield, *inter alia*, to: 1) charge the same prices as Kresge for items sold by both of them, the price to be set by Kresge absent mutual agreement; 2) offer merchandise at a price competitive with the same or similar merchandise offered in the trading area; and 3) restrict the sale of

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The essence of *Dandridge v. Williams*, controls in this case. Once the state makes funds available to all its Medicaid eligibles, it is within the state's power to determine the level of benefits and types of services granted. 397 U.S. at 481.

57. *See* note 22 *supra*. Judge Kalodner's dissent also discussed the constitutional issue. 523 F.2d at 631–35.

58. Ashwander v. TVA, 297 U.S. 288, 346 (1936) (Brandeis, J., concurring).

In Hagans v. Lavine, 415 U.S. 528 (1974), the Court reversed the dismissal of a suit in which the New York regulations under the AFDC provisions of the Social Security Act, 42 U.S.C. §§ 601–660 (Supp. V 1975), were challenged. The Court remanded, requiring the district court to consider the statutory challenge before reaching the constitutional issue. 415 U.S. at 550.

The Supreme Court indicated that the same priority of consideration should be applied in the Medicare setting. Doe v. Westby, 420 U.S. 968 (1975), *vacating and remanding* 383 F. Supp. 1143 (D.S.D. 1974). The lower court had reached a constitutional challenge to South Dakota's limits on payments for abortions under Medicaid without considering the consistency of the regulations with the Medicaid Act itself. The Court instructed the district court to reconsider in light of *Hagans v. Lavine*.

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1. Evans v. S.S. Kresge Co., 544 F.2d 1186, 1187 (3d Cir. 1976). The K-Mart trade name was used by Kresge in its attempt to develop an image as a discount merchandiser offering quality merchandise at competitive prices. *Id.* at 1186. Kresge operated a number of stores under this name. *Id.*

non-food merchandise to specified categories of goods.[2] These license terms were enforced by Kresge by supplying Hempfield with "Identical Pricing Books" to be used in pricing "like items" (merchandise sold by both of them) and by policing the Hempfield stores for violations.[3] Kresge licensed the K-Mart name to Hempfield believing that the high sales volume necessary to make the K-Mart discount business profitable could best be achieved by drawing upon the potential buying power of frequent grocery store customers.[4] Although under the agreement the Hempfield grocery stores were held out to the public as part of the K-Mart enterprise, they were actually independent operations.[5]

In 1969, Hempfield's leases were terminated and it filed a petition in bankruptcy soon thereafter.[6] Plaintiff, Hempfield's trustee in bankruptcy, then brought a treble-damage action against Kresge in 1971 in the United States District Court for the Western District of Pennsylvania,[7] alleging that the restrictions imposed upon Hempfield in the licensing agreement constituted per se violations of section 1 of the Sherman Act.[8] Plaintiff

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2. *Id.* at 1186-87. The agreement also provided that Hempfield could not enter into any fair trade agreement nor issue trading stamps without express approval by Kresge. Furthermore, Hempfield was required to use specified equipment provided by Kresge. *Id.* at 1187. The trial court's rulings against Hempfield on these restrictions were not appealed. *Id.* at 1187 n.10.

3. Evans v. S.S. Kresge Co., 394 F. Supp. 817, 826, 827 (W.D. Pa. 1975). The district court noted that as a result of the policing policy, Hempfield was directed on several occasions to remove unauthorized merchandise or to discontinue its sale when the stock on hand was exhausted. *Id.* at 826.

4. 544 F.2d at 1186. Kresge chose to license Hempfield rather than operate a grocery business itself because it had no food merchandising experience and lacked distribution sources. *Id.*

5. *Id.* at 1187. The independent nature of the business was evidenced by the following: 1) Hempfield was not permitted to use any Kresge trade name, including K-Mart, on any of its merchandise; 2) Hempfield was not permitted to use the K-Mart name on its checks, business stationery, or pricing labels; 3) Hempfield was not restricted by Kresge with respect to supply sources; and 4) neither Hempfield nor Kresge purchased any goods or services from the other. *Id.*

6. *Id.*

7. 394 F. Supp. at 823.

8. Section 1 provides in pertinent part: "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the serveral states, or with foreign nations is declared to be illegal." *Id.* 15 U.S.C. § 1 (1970). Although the prohibition of section 1 is literally absolute, the Supreme Court of the United States construed this section early in the Act's history as precluding only those arrangements that *unreasonably* restrain competition. Standard Oil Co. v. United States, 221 U.S. 1 (1911). In Chicago Bd. of Trade v. United States, 246 U.S. 231 (1918), the Court articulated the so-called "rule of reason":

> [T]he legality of an agreement or regulation cannot be determined by so simple a test, as whether it restrains competition. Every agreement concerning trade, every regulation of trade, restrains. To bind, to restrain, is of their very essence. The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition. To determine that question the court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; the nature of the restraint and its effect, actual or probable. The history of the restraint, the evil believed to

alleged that the price restrictions resulted in an illegal horizontal[9] price-fixing arrangement, and that the product restrictions interfered with Hempfield's right to exercise its independent business judgment,[10] thus "'[contributing] to Hempfield's business failure.'"[11] Upon Kresge's motion for summary judgment, the district court held that subject matter jurisdiction was lacking in that the restrictions complained of neither occurred in nor substantially affected interstate commerce.[12] The court did, however, proceed to discuss the case on its merits in "the interests of judicial economy," and found that the restrictions imposed by Kresge upon Hempfield were not violative of section 1 under either the per se or rule of reason standard.[13] The court then granted Kresge's motion for summary judgment.[14] On appeal, the United States Court of Appeals for the Third Circuit, after finding that subject matter jurisdiction did exist,[15] affirmed the grant

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exist, the reason for adopting the particular remedy, the purpose or end sought to be attained, are all relevant facts.

Id. at 238.

Complementing the "rule of reason" is the *per se* rule, explained in Northern Pac. Ry. Co. v. United States, 356 U.S. 1 (1958), as follows: "[T]here are certain agreements or practices which because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use." *Id.* at 5. *See generally* Von Kalinowski, *The Per Se Doctrine — An Emerging Philosophy of Antitrust Law*, 11 U.C.L.A. L. Rev. 569 (1964).

9. A horizontal restraint is one established by entities at the same functional level of the economic system, such as a group of supermarket owners agreeing to limit the geographic area in which each will operate. *See* United States v. Topco Assocs., 405 U.S. 596 (1972). A vertical restraint is one which originates at one level of the economic distribution system and is imposed on businesses at another level, as in a manufacturer's refusal to allow his vendees to sell his products to specified customers or outside certain areas. *See* United States v. Arnold, Schwinn & Co., 388 U.S. 365, 372 (1967).

10. 394 F. Supp. at 826; *see* notes 24–29 and accompanying text *infra*.

11. 394 F. Supp. at 826.

12. *Id.* at 833–42. The court applied the "come to rest doctrine" to find that the groceries sold by Hempfield were not in the flow of interstate commerce. It said that even though many of the items were obtained from sources outside of Pennsylvania, the sales to the public were not in the flow of interstate commerce because once the items reached the stores' shelves they "came to rest"; at this point they were so diverted from interstate commerce that subsequent sales to customers were purely local transactions. *Id.* at 836. For cases discussing the "come to rest doctrine," *see* Cliff Food Stores v. Kroger, 417 F.2d 203, 210 (5th Cir. 1969); United States v. Food & Grocery Bureau, 43 F. Supp. 974, 977 (S.D. Cal. 1942). The district court concluded that interstate commerce was not affected by the Kresge-Hempfield agreement because 1) Hempfield did not allege that the price and product restrictions restricted its sources of supply or the prices it paid for the supplies; 2) the restrictions did not deprive suppliers of their freedom to sell to Hempfield in a competitive market; 3) the restrictions did not drive Hempfield out of business as a retailer of its suppliers' merchandise. 394 F. Supp. at 833–42. For a discussion of the "affecting commerce" problem, *see* United States v. Starlite Drive-In, 204 F.2d 419 (7th Cir. 1953).

13. 394 F. Supp. at 843.

14. *Id.* at 849.

15. 544 F.2d at 1188–90. The Third Circuit, relying upon the United States Supreme Court's decision in Hospital Bldg. Co. v. Trustees of Rex Hosp., 425 U.S. 738 (1976), held that the jurisdictional requirement was met in light of Hempfield's $400,000 in out-of-state purchases and the fact that the challenged pricing restriction was used by Kresge on a nationwide basis in its K-Mart Food Store agreements. 544 F.2d at 1189–90.

of summary judgment on the ground that the restrictions did not violate section 1 under either the per se or rule of reason test. *Evans v. S.S. Kresge Co.*, 544 F.2d 1184 (3d Cir. 1976).

The particular business arrangement in *Kresge*[16] apparently had not been presented for judicial analysis of its legality under the antitrust laws prior to this case. However, the types of conduct involved in the arrangement that allegedly violated section 1 — horizontal price fixing and interference with independent business judgment — have a well-established history of interpretive case law.

As a subject of special solicitude under the antitrust laws, price fixing has been the focus of some of the Supreme Court's most unequivocal language. In *United States v. Trenton Potteries Co.*,[17] the Court was confronted with an agreement to fix and maintain uniform prices by manufacturers who controlled eighty-two percent of the domestic sanitary pottery business.[18] In finding the agreement illegal, the Court stated: "[I]t has . . . often been decided and always assumed that uniform price fixing by those controlling in any substantial manner a trade or business in interstate commerce is prohibited by the Sherman Law, despite the reasonableness of the prices agreed upon."[19] Even when prices have been fixed indirectly,[20] the Court has firmly declared the dogma: "Whatever economic justification particular price fixing agreements may be thought to have, the law does not permit an inquiry into their reasonableness. *They are all banned because of their actual or potential threat to the central nervous system of the economy.*"[21] The Court has emphasized that no showing of competitive abuses or evils which such agreements are allegedly designed to eliminate or alleviate may serve as a defense.[22] Thus, price fixing has long been considered per se an unreasonable restraint of the trade.[23]

The per se rule has also been applied by the Supreme Court in numerous antitrust cases where the independent business judgment of a vendor has been impinged upon by others. For example, in *Dr. Miles Medical Co. v. John D. Park & Sons*,[24] a drug manufacturer's imposition of *minimum* resale prices upon his vendees was condemned as a per se violation of section 1 because, *inter alia*, it restricted the dealers' freedom of trade.[25] Forty years

16. For a discussion of the pertinent provisions of the Kresge-Hempfield agreement, *see* notes 1 & 2 and accompanying text *supra*.

17. 273 U.S. 392 (1927).

18. *Id.* at 394.

19. *Id.* at 398; *see* Addyston Pipe & Steel Co. v. United States, 175 U.S. 211, 238 (1899) (question of reasonableness of contractual agreement to fix prices not open to the courts at common law and same rule should apply under the Sherman Act).

20. *See* United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 216 (1940) (individuals and major oil companies acted to stabilize gasoline prices by agreements to remove excess or "distress" gasoline from the market).

21. *Id.* at 226 n.59 (emphasis added).

22. *Id.* at 218.

23. *See* note 8 supra. As stated previously, an agreement which is not found to be per se illegal must be examined under the rule of reason test. For an explanation of this test, *see* note 9 *supra*.

24. 220 U.S. 373 (1911).

25. *Id.* at 403–07.

later, in *Kiefer-Stewart Co. v. Joseph E. Seagram & Sons,*[26] the Court applied the per se standard to strike down an agreement among competing liquor distributors that fixed *maximum* resale prices, noting that "agreement[s] among competitors to fix maximum resale prices . . . no less than those to fix minimum prices, cripple the freedom of traders and thereby restrain their ability to sell in accordance with their own judgment."[27] Furthermore, in *United States v. General Motors Corp.,*[28] collaborative action directed at certain General Motors franchisees by the manufacturer and other General Motors dealers was declared per se illegal because it deprived the franchisees of their freedom to sell automobiles through discount houses.[29] The freedom of independent business entities to make their competitive decisions unhampered by external pressure is thus a basic principle of antitrust policy.

The Third Circuit in *Kresge* was therefore confronted with a business agreement and practice which appeared, at least on the surface, to present a classical per se violation of section 1 — horizontal price fixing coupled with other restrictions upon Hempfield's exercise of its independent business judgment. After disposing of the jurisdictional issue,[30] the court noted that before an arrangement in a particular case may be subject to the per se rule: 1) the business relationship between the parties must be "one with which the courts have had 'considerable experience,' "[31] and 2) the restrictions embodied in the relationship must be " 'naked restraints of trade with no purpose except [the] stifling of competition.' "[32] After commenting that the district court had found the relationship in the instant case to be akin to a franchise,[33] the present court characterized the relationship as more like a

26. 340 U.S. 211 (1951).

27. *Id.* at 213; *see* Klor's, Inc. v. Broadway-Hale Stores, Inc., 359 U.S. 207 (1959), where a group boycott was subjected to per se treatment as it prevented the affected merchants from selling according to their own judgment. Broadway-Hale, a chain department store, operated one of its stores next door to an appliance store operated by Klor's. *Id.* at 208. So located, the two stores were competitors for retail appliance sales. *Id.* Broadway-Hale used its "monopolistic" buying power to induce 10 national appliance manufacturers and their distributors not to deal with Klor's or to sell to it only on highly unfavorable, discriminatory terms. *Id.* at 209. The effect was "to [take] from Klor's its freedom to buy appliances in an open competitive market and [drive] it out of business as a dealer in the manufacturers' products. It [also] deprive[d] the manufacturers and distributors of their freedom to sell to Klor's. . . ." *Id.* at 213.

28. 384 U.S. 127 (1966).

29. *Id.* at 144. General Motors, aided by the policing efforts of local dealers, targeted dealers who were selling through discount houses and pressured them to abandon the practice. *Id.* at 135–38. Not only did this interfere with the targeted dealers' freedom of trade, it also eliminated the discount houses from access to the market for Chevrolets. *Id.* at 145. The Supreme Court held the action per se illegal. *Id.*

30. *See* note 15 and accompanying text *supra.*

31. 544 F.2d at 1191, *quoting* United States v. Topco Assocs., 405 U.S. 596, 608 (1972).

32. *Id.*

33. 544 F.2d at 1191. Provisions in the licensing agreement that led the district court to its "franchise" conclusion included: 1) payments to Kresge by Hempfield of a percentage of gross sales in excess of a given figure as license fees; 2) common advertising, directed by Kresge, with the cost shared by Hempfield; and 3) discontinuance by Hempfield of its use of the K-Mart or any related trade name upon termination of the agreement. 394 F. Supp. at 844.

"concession"[34] but emphasized that precise labeling was unnecessary since the relevant inquiry was simply "whether there has been sufficient judicial examination of, and experience with, the hybrid business arrangement at issue here."[35] Finding that the antitrust statutes had apparently never been invoked to challenge a business relationship similar to the Kresge-Hempfield arrangement,[36] the court indicated a " 'need to know more than we do about the actual impact of these arrangements on competition to decide whether they have such a "pernicious effect on competition and lack . . . any redeeming virtue" and therefore should be classified as *per se* violations of the Sherman Act.' "[37]

In addition to its inability to find prior judicial consideration of, and thus the requisite "considerable experience" with, the *Kresge* arrangement to declare it per se illegal, the court was unable to find that the restrictions involved met the second portion of the test—that they were "naked restraints of trade with no purpose except stifling of competition."[38] This result was reached because a prerequisite of a horizontal restraint of trade is an agreement between *competitors,* and the court found that Kresge and Hempfield were not competitors.[39] The Third Circuit stated that although the parties arguably appeared to be competitors because certain non-food items could be purchased from either Kresge or Hempfield, the fact that such goods were presented to the public under a common K-Mart marquee made it as though these items were simply available at two different locations in a single vendor's (Kresge's) establishment.[40] Furthermore, the court found that the restrictive terms in the arrangement served a legitimate business purpose: By stimulating the business and efficiency of both the discount house and the grocery store, the restrictions, rather than stifling competition, enabled the total operation to function as an effective competitor to

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34. 544 F.2d at 1192. The Third Circuit reasoned that Hempfield, by using the name K-Mart Foods on its marquee and thus appearing as K-Mart to the public, was in effect operating within the K-Mart complex as a "concession." *Id.*

35. *Id.*

36. *Id.* at 1191. The court was also unable to find any nonjudicial legal discussion of the relationship created by the agreement. *Id.*

37. *Id.* at 1192, *quoting* White Motor Co. v. United States, 372 U.S. 253, 263 (1963), *quoting* Northern Pac. Ry. Co. v. United States, 356 U.S. 1, 5 (1958).

38. 544 F.2d at 1192; *see* notes 31 & 32 and accompanying text *supra.*

39. 544 F.2d at 1192. The court quoted from United States v. Columbia Pictures Corp., 169 F. Supp. 888 (S.D.N.Y. 1961): "[B]efore we may say that . . . agreements [imposing such restraints] are inherently unlawful, we must find that the agreements were made between competitors, actual or potential, dealing in competing products in a relevant market." *Id.* at 893.

The court also noted that while some vertical restraints, such as resale price maintenance, are per se illegal, neither party to the instant action argued that the restrictions here involved were vertical in nature. 544 F.2d at 1192 n.25.

40. 544 F.2d at 1193. The court noted that the uncontradicted affidavit of one of the Hempfield incorporators showed that the parties did not intend to compete with one another, and that the absence of competition was essential to their business arrangement. Moreover, the district court had found that Kresge and Hempfield were not competitors because only between two and five percent of Hempfield's merchandise was also sold by the K-Mart department stores. *Id.*

other department store and food discounters.[41] The court therefore regarded per se treatment as inappropriate.[42]

Although plaintiff's attack on the licensing agreement restrictions was based solely upon an argument of per se illegality,[43] the Third Circuit also discussed the restrictions' validity under the rule of reason. Applying that test as formulated by Justice Brandeis in *Chicago Board of Trade v. United States,*[44] the court concluded that the restraints, imposed as they were to enhance the business and efficiency of both parties and allow them to stand as a unified competitor in the discount and food markets,[45] were such as "'merely regulate and perhaps thereby promote competition [rather than] such as may suppress or even destroy competition.'"[46] The Third Circuit therefore affirmed the district court's granting of Kresge's motion for summary judgment.[47]

The Third Circuit's refusal to apply the per se standard to the Kresge-Hempfield arrangement appears at least superficially sound when considered in the context of cases involving restrictive covenants in shopping center leases and trademark licensing.[48] However, the factual differences between these cases and *Kresge* may dilute their precedential force. In *Savon Gas Stations v. Shell Oil Co.,*[49] a covenant in a shopping center lease providing that the lessor would not permit the use of other property in the shopping center for a competitive service station was found to be a reasonable ancillary restraint of trade, and thus not violative of section 1.[50] Since the covenant clearly barred the lessor itself from operating a competing business in the shopping center, it is arguable that the agreement eliminating competition between Kresge, as lessor, and Hempfield, as lessee, was also a reasonable ancillary restraint. However, in *Savon,* the Fourth Circuit was careful to note that no price-fixing agreement and no direct interference with the plaintiff's business was involved; the restrictive covenant resulted only in the lessor's refusal to allow an adjacent service station (plaintiff) direct access to the shopping center, thereby denying it the

41. *Id.*
42. *Id.*
43. *Id.* at 1194.
44. 246 U.S. 231 (1918). For an explanation of this test, *see* note 8 *supra.*
45. *See* text accompanying note 41 *supra.*
46. 544 F.2d at 1194, 1196, *quoting* Chicago Bd. of Trade v. United States, 246 U.S. 231 (1918). Since the burden of proof to establish a section 1 violation is upon the plaintiff, and since the plaintiff failed to adduce any evidence to support a finding of a violation under the rule of reason standard, the court, upon the record presented, could not have found such a violation. *See* 544 F.2d at 1193–96. The court quoted at length from the uncontradicted affidavit of one of the founders of Hempfield's predecessor, who had negotiated the Kresge license. He stated, *inter alia:* "I agreed to [the price restrictions] because [they] essentially accomplished one purpose of two separate operations under one name, and the identical pricing would avoid customer confusion and damage to the low-price discount image that we were both trying to accomplish." *Id.* at 1195.
47. 544 F.2d at 1196.
48. *See* notes 49–51 & 58–60 and accompanying text *infra.*
49. 309 F.2d 306 (4th Cir. 1962), *cert. denied,* 372 U.S. 911 (1963).
50. *Id.* at 310; *accord,* Goldberg v. Tri-States Theatre Corp., 126 F.2d 26 (8th Cir. 1942).

use of the shopping center property as part of its place of business.[51] In *Kresge* both price fixing and direct interference with Hempfield's business were present.[52] Moreover, unlike *Savon,* wherein the lessor voluntarily restricted its own behavior, the lessor in *Kresge* restricted the behavior of its lessee, Hempfield, an independent business entity.[53]

Although K-Mart is a trade name and not a trademark, the rules governing its use are generally similar to those governing the use of trademarks.[54] Just as the owner of a tradmark has the right to impose *reasonable* restraints on its licensees calculated to protect the reputation of its product,[55] Kresge, as a trade name licensor to Hempfield, enjoyed the same rights with respect to the K-Mart name. In fact, protection of the "low price 'K-Mart' discounting image"[56] was part of the asserted justification for the restraints imposed upon Hempfield.[57] In *Susser v. Carvel Corp.,*[58] the Second Circuit upheld a section 1 challenge of a clause in a franchising contract requiring the franchisee-retailers to sell only the franchisor's products or those approved by the franchisor. The case is a useful vehicle for analyzing the result reached in *Kresge,* notwithstanding the fact that a franchise was involved in *Carvel* whereas the Kresge-Hempfield relationship was characterized by the Third Circuit as a concession.[59] Looking beyond the labels, both Hempfield and the Carvel franchisees were permitted to use their licensor's trade name or trademark on their stores.[60] However, the Carvel franchisees were allowed to use the Carvel name in their advertising displays and on the products they sold,[61] while Hempfield had no such rights with respect to the K-Mart name.[62] The antitrust significance of this distinction lies in the fact that, even inside a Carvel store, one would identify the products sold with the Carvel name, but once past the K-Mart marquees a customer could perceive the independent nature

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51. 309 F.2d at 310.

52. *See* notes 2 & 3 and accompanying text *supra.*

53. For evidence of Hempfield's independence, *see* notes 2 & 5 and accompanying text *supra.*

54. *See* Stover v. Farmers' Educ. & Coop. Union, 250 F.2d 809, 811 (8th Cir. 1958), *cert. denied,* 356 U.S. 976 (1958). In general, a trademark is applicable to a vendible commodity to which it is affixed, whereas a trade name is applicable to a business and its goodwill. American Steel Foundries v. Robinson, 269 U.S. 372, 380 (1926).

55. Susser v. Carvel Corp., 332 F.2d 505, 517 (2d Cir. 1964), *cert. dismissed as improvidently granted,* 381 U.S. 125 (1965). However, a trademark can not be legally used as a vehicle to impose restrictions that would otherwise violate section 1. Timken Roller Bearing Co. v. United States, 341 U.S. 593, 599 (1951). In fact, the Lanham Act, 15 U.S.C. §§ 1051–1127 (1970), imposes sanctions for the use of a trademark "to violate the antitrust laws of the United States." *Id.* § 1115(b)(7).

56. 544 F.2d at 1193.

57. *Id.*

58. 332 F.2d 505 (2d Cir. 1964).

59. *See* note 34 and accompanying text *supra.* The Second Circuit stated: "The antitrust laws certainly do not require that a licensor of a trademark permit his licensees to associate with the trademark other products unrelated to those customarily sold under the mark." 332 F.2d at 517. The franchisees in *Carvel* sold the franchisor's soft ice cream product. *Id.* at 508–09.

60. *Carvel, Id.* at 517; *Kresge,* 544 F.2d at 1186–87.

61. 332 F.2d at 517.

62. *See* note 5 *supra.*

of the Kresge and Hempfield operations.[63] This attenuates the force of the argument that restrictions upon Hempfield were necessary to protect the "low price 'K-Mart' discounting image."[64]

It is also significant that price fixing, present in *Kresge,* was absent in *Carvel* at the time of trial and appeal, but the trial judge had found that price-fixing provisions in earlier Carvel franchise agreements were per se violations of section 1.[65] In language which, if applicable to the tightly controlled Carvel franchise system, is a fortiori applicable to the simple Kresge-Hempfield licensor-licensee relationship, the trial court stated: "The cases outlawing price fixing have been so sweeping that *there would appear to be no room for saying that . . . price fixing may be justified as ancillary to a valid business operation.*"[66]

Indeed, the Third Circuit's *Kresge* decision accords little weight to one of the most oft-repeated dictates of the Supreme Court in the antitrust field — that an agreement to fix prices is per se an unreasonable restraint of trade.[67] As the Supreme Court has stated: "It is not for the courts to determine whether in particular settings price-fixing serves an honorable or worthy end."[68] The Third Circuit's refusal to apply the per se standard, at least to the price fixing provision in the Kresge-Hempfield agreement, is thus open to serious question. The court's justification for its position, that Kresge and Hempfield were not competitors and therefore no horizontal price fixing arrangement could be established,[69] is tenuous in at least two respects. First, Kresge and Hempfield were noncompetitors not because the market cast them in this relationship, but because they *agreed* not to compete.[70] Second, the very fact that they had to agree to this arrangement demonstrates that they were at least *potential* competitors; and as the court itself recognized, even agreement between potential competitors can establish a per se violation of section 1.[71]

Although the Third Circuit characterized the Kresge-Hempfield arrangement as a "joint venture" by noting that the parties "acted as 'partners' in establishing and operating under joint merchandising and pricing policies" thereby competing as a unit against others in the market,[72] such a determination should not vindicate otherwise illegal restraints of

63. *See* note 5 and accompanying text *supra.*

64. 544 F.2d at 1193; *see* text accompanying notes 56 & 57 *supra.*

65. Susser v. Carvel Corp., 206 F. Supp. 636, 649 (S.D.N.Y. 1962). No appeal was taken from this finding by the trial court. 332 F.2d at 509.

66. 206 F. Supp. at 649 (emphasis added). The court noted that "[i]t has been established beyond any possibility of dispute that agreements fixing prices are illegal *per se* under Section 1 of the Sherman Act." *Id.* at 648, *citing* Dr. Miles Medical Co. v. John D. Park & Sons, 220 U.S. 373 (1911), *and* United States v. Trenton Potteries Co., 273 U.S. 392 (1927).

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

68. United States v. National Ass'n of Real Estate Bds., 339 U.S. 485, 489 (1950).

69. *See* notes 39 & 40 and accompanying text *supra.*

70. 544 F.2d at 1187, 1193.

71. *Id.* at 1192; *see* note 39 *supra.* The court's conclusion that a horizontal limitation was not present resulted from a finding that Kresge and Hempfield were not *actual* competitors. F.2d at 1192. There was no discussion of the parties as *potential* competitors.

72. *Id.*

trade. As the Supreme Court stated in *Timken Roller Bearing Co. v. United States:*[73] "[W]e find [no] support in reason or authority for the proposition that agreements between *legally separate* persons and companies to suppress competition among themselves and others can be justified by labeling the project a "joint venture." Perhaps every agreement and combination to restrain trade could be so labeled."[74] Even if some members of the public were induced to believe that K-Mart and Hempfield were a single entity, Kresge and Hempfield were legally separate companies,[75] and therefore within the purview of the *Timken* language.

The Third Circuit's exoneration of the product restrictions in the Kresge-Hempfield agreement,[76] while not as direct an affront to Supreme Court holdings as its exoneration of the price-fixing arrangement, is nonetheless dubious in light of the cases that have developed and reiterated one of the underpinnings of antitrust policy — the freedom of independent business entities to make independent decisions with respect to the conduct of their operations.[77] Although Kresge, as a trade name licensor, had the right to impose *reasonable* restraints upon Hempfield,[78] the visible independence of the two businesses behind the K-Mart marquees raises the question whether *any* restrictions were *reasonably* necessary to protect the "low price 'K-Mart' discounting image."[79] Moreover, whether the restraints other than price fixing should have been declared valid even under the rule of reason is questionable, since the Kresge-Hempfield relationship was not as tightly woven as that between the franchisor and franchisees in *Carvel,*[80] and a horizontal relationship was involved in *Kresge* as contrasted with a vertical one in *Carvel.*[81] Since the plaintiff bore the burden of establishing that the arrangement constituted a section 1 violation,[82] and since it advanced arguments only in support of a finding of per se illegality,[83] the court's conclusion that no section 1 violation was proven on the record — "that the challenged restraints 'merely regulates [*sic*] and perhaps thereby promote

73. 341 U.S. 593 (1951).

74. *Id.* at 598. In *Timken* the Court found a per se violation of section 1 where the dominant American producer of roller bearings used its trademark licensing agreements to divide the international market amongst itself and British and French producers. *Id.* at 597-99.

75. For the manifestations of this independence of one another at the retail sales level, *see* note 5 *supra.*

76. For a discussion of the terms of this agreement, *see* note 2 and accompanying text *supra.*

77. For a discussion of the Supreme Court's views on this issue, *see* notes 24-29 and accompanying text *supra.*

78. *See* note 55 and accompanying text *supra.*

79. 544 F.2d at 1193; *see* notes 5 & 59-64 and accompanying text *supra.*

80. *See* notes 59-62 and accompanying text *supra.*

81. For an explanation of horizontal and vertical restraints, *see* note 9 *supra.* The apparent inappropriateness of the Third Circuit's refusal to characterize the relationship between Kresge and Hempfield as horizontal because of the absence of *actual* competition between them is discussed at notes 69-71 and accompanying text *supra.*

82. 544 F.2d at 1193; *see* note 46 *supra.*

83. 544 F.2d at 1194.

competition,' "[84] — is unassailable so long as one ignores the fact that Kresge and Hempfield were potential competitors who laid to rest any chance of actual competition between them through agreement.[85]

The Third Circuit appears to have opened the door for competitors, actual or potential, situated in close geographic proximity to one another, to effectively eliminate competition between themselves by the simple expedient of operating under a common name and holding themselves out to the public as noncompetitors. Even price fixing, long thought to be illegal per se,[86] will have an opportunity to thrive under the guise of agreements between noncompetitors who have consciously decided and agreed not to compete with one another. Since the Supreme Court's absolute proscription of price fixing admits no such exception,[87] the *Kresge* decision may be viewed as an unwarranted relaxation of the judiciary's vigilance in the price-fixing area.

Reginald A. Krasney

CONSUMER LAW — TRUTH IN LENDING ACT — DISCLOSURE OF ACCELERATION CLAUSE IN INSTALLMENT CONTRACT NOT REQUIRED WHEN STATE LAW PROVIDES FOR THE REBATE OF UNEARNED INTEREST.

Johnson v. McCrackin-Sturman Ford, Inc. (1975)

In order to finance the purchase of a used automobile, plaintiffs William and Joan Johnson entered into a retail installment contract with McCrackin-Sturman Ford, Inc. (McCrackin-Sturman).[1] A copy of the contract and a disclosure statement were delivered to plaintiffs at the time of sale.[2] Although the contract contained a provision granting McCrackin-Sturman the right to accelerate payment in the event of plaintiffs' default,[3]

84. *Id.* at 1196, *quoting* Chicago Bd. of Trade v. United States, 246 U.S. 231, 238 (1918).

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

86. *See* notes 17–23, 67 & 68 and accompanying text *supra.*

87. *See* notes 17–23, 67 & 68 and accompanying text *supra.*

1. Johnson v. McCrackin-Sturman Ford, Inc., 527 F.2d 257, 260 (3d Cir. 1975). Under the retail installment contract, plaintiffs were required to pay in 30 monthly installments the purchase price of the vehicle less a downpayment, plus finance and other charges. *Id.*

2. *Id.* at 260–61. Under the Truth in Lending Act, the creditor, McCrackin-Sturman, was required to disclose certain credit information to the plaintiff-consumers. *See* Truth in Lending Act, § 128(a), 15 U.S.C. § 1638(a) (1970); Regulation Z, 12 C.F.R. § 226.8(b) (1976). Basically, such disclosures must be made on a separate statement and presented in a clear and conspicuous manner. Truth in Lending Act, § 121(a), 15 U.S.C. § 1631(a) (1970); Regulation Z, 12 C.F.R. § 226.8(a) (1976).

3. 527 F.2d at 261. The acceleration clause was located in a contractual provision labeled "Default." In this same provision the creditor was given rights in addition to acceleration, including the right to repossess and resell the automobile and the right to obtain from the borrower reasonable attorney's fees and other expenses incurred by the creditor in effecting such repossession and resale. *Id.*

this right was not set forth in the disclosure statement.[4] Plaintiffs made none of the required payments, and the automobile was ultimately repossessed by Ford Motor Credit Company, the assignee of the contract.[5] Alleging that the failure to include the acceleration provision in the disclosure statement constituted a violation of section 128(a)(9) of the Truth in Lending Act (Act)[6] and section 226.8(b)(4) of Regulation Z[7] promulgated thereunder, plaintiffs instituted an action against McCrackin-Sturman and Ford Motor Credit in the United States District Court for the Western District of Pennsylvania.[8] The district court subsequently granted plaintiffs the requested relief.[9] On appeal,[10] the United States Court of Appeals for the

4. *Id.* The disclosure statement did contain a provision delineating the charges that would be assessed against plaintiffs in the event of late payment of an installment. *Id.* In addition, it set forth the method for computing the portion of the finance charge that would be rebated if plaintiffs prepaid their obligation. *Id.*

5. *Id.* Under the contract, the seller retained the right to repossess the automobile in the event of default. *Id.*

6. 15 U.S.C. § 1638(a)(9) (1970). Section 128(a)(9) provides in pertinent part: "In connection with each consumer credit sale not under an open end credit plan, the creditor shall disclose each of the following items which is applicable: ". . . [t]he default, delinquency, or similar charges payable in the event of late payments." *Id.*

The sale in *Johnson* was not made pursuant to an open end credit plan and therefore fell within section 128(a)(9) of the Act. For the statutory definition of "an open end credit plan," *see id.* § 1602(i). Basically, open end credit is credit of an ongoing nature, under which there is no fixed date by which the obligation must be fully paid. Examples include credit extended via credit cards and revolving charge accounts. On the other hand, consumer credit not under an open end credit plan is credit extended for a specific length of time, with payments of equal amounts due at set intervals. This type of credit is exemplified by a typical bank loan or a retail installment contract such as that in *Johnson.* Galie, *The Acceleration Clause as a Truth in Lending Disclosure: The End of a Dilemma?*, 93 BANKING L.J. 317, 319 (1976).

7. 12 C.F.R. § 226.8(b)(4) (1976). Section 226.8(b)(4) provides in pertinent part: "In any transaction subject to this section, the following items, as applicable, shall be disclosed: . . . (4) the amount, or method of computing the amount, of any default, delinquency, or similar charges payable in the event of late payments." *Id.*

8. Johnson v. McCrackin-Sturman Ford, Inc., 381 F. Supp. 153 (W.D. Pa. 1974). Jurisdiction was based upon section 130(e) of the Truth in Lending Act, 15 U.S.C. 1640(e) (1970). 381 F. Supp. at 154.

9. *Id.* at 154. All parties originally moved in the district court for summary judgment. Plaintiffs' motion for summary judgment against McCrackin-Sturman was granted, but its motion against Ford Motor Credit was denied without prejudice. *Id.* at 156. Both McCrackin-Sturman's and Ford Motor Credit's motions for summary judgment were denied. *Id.* The district court concluded that acceleration of the loan was a charge within the meaning of section 128(a)(9) of the Act and section 226.8(b)(4) of Regulation Z. *Id.* Relying upon Garza v. Chicago Health Clubs, Inc., 347 F. Supp. 955 (N.D. Ill. 1972), the court held that a creditor's right to accelerate payment was precisely the "type of disclosure the Truth in Lending Act was intended to require." 381 F. Supp. at 155–56. In addition, the court rejected the defendants' contention that since the acceleration clause was not automatically imposed, it did not have to be disclosed under section 226.8(b)(4) of Regulation Z. *Id.* For an analysis of the district court opinion, *see* WAYNE L. REV. 1153 (1975). *See generally* Federal Reserve Board Staff Opinion Letter No. 591, [1969–1974 Transfer Binder] CONS. CRED. GUIDE (CCH) ¶ 30,834 (Apr. 10, 1972); Federal Reserve Board Staff Opinion Letter No. 290, [1969-1974 Transfer Binder] CONS. CRED. GUIDE (CCH) ¶ 30,528 (Mar. 19, 1970); Federal Reserve Board Staff Opinion Letter, [1969–1974 Transfer Binder] CONS. CRED. GUIDE (CCH) ¶ 30,404 (June 23, 1969).

10. Since the district court certified only the grant of summary judgment against McCrackin-Sturman as final, the appeals from the other district court rulings were dismissed by the Third Circuit for lack of an appealable order. 527 F.2d at 262.

Third Circuit[11] reversed, *holding* that since a state statutory provision[12] requires creditors to rebate the unearned portion of the finance charge, a failure to disclose a right of acceleration does not violate section 128(a)(9) of the Act or section 226.8(b)(4) of Regulation Z. *Johnson v. McCrackin-Sturman Ford, Inc.*, 527 F.2d 257 (3d Cir. 1975).

In 1969, Congress enacted the Truth in Lending Act in order to ensure for consumers a meaningful disclosure of credit costs, which then could be readily compared to facilitate the informed use of credit.[13] In order to effectuate this purpose, the Federal Reserve Board (Board), pursuant to congressional authority,[14] promulgated Regulation Z,[15] which, together with the Act, requires the creditor to make certain disclosures to the consumer in most credit transactions.[16]

Prior to the instant case, numerous district courts had confronted the question of whether an acceleration clause is required to be disclosed. Since the Truth in Lending Act and its supplemental regulations require the

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11. The case was heard by Judges Van Dusen, Maris, and Hunter. Judge Hunter wrote the opinion of the court.

12. *See* note 33 *infra.*

13. Truth in Lending Act, § 102, 15 U.S.C. § 1601 (1970); *see* Mourning v. Family Publications Serv., Inc., 411 U.S. 356, 364–65 (1973); Philbeck v. Timmers Chevrolet, Inc., 499 F.2d 971, 976 (5th Cir. 1974). The Act was later amended to include an additional purpose: "to protect the consumer against inaccurate and unfair credit billing and credit card practices." 15 U.S.C. § 1601 (Supp. V 1976) (amending 15 U.S.C. § 1601 (1970)). For a discussion of the amendments to the Act, *see* Comment, *Consumer Protection: Amendments To Truth in Lending Act*, 28 OKLA. L. REV. 567 (1975).

14. Section 105 of the Act, 15 U.S.C. 1604 (1970), gives the Board authority to prescribe regulations which, in the judgment of the Board, are necessary to execute the purpose of the Act. In Mourning v. Family Publications Serv., Inc. 411 U.S. 356 (1973), the United States Supreme Court recognized the power granted the Board by section 105 of the Act, stating:

> To accomplish its desired objective, Congress determined to lay the structure of the Act broadly and to entrust its construction to an agency with the necessary experience and resources to monitor its operation. Section 105 delegated to the Federal Reserve Board broad authority to promulgate regulations necessary to render the Act effective.

Id. at 365; *accord*, Philbeck v. Timmers Chevrolet, Inc., 499 F.2d 971, 976 (5th Cir. 1974).

15. 12 C.F.R. §§ 226.1–.14 (1976). In addition to promulgating Regulation Z, the Board, under the authority delegated to it by Congress, has issued and continues to issue formal interpretations of Regulation Z's provisions. *Id.* §§ 226.101–.1002. Furthermore, from time to time members of the Board issue Federal Reserve Board staff opinion letters to explain particular provisions of the Act and Regulation Z. Thus, in addition to case law, there are four sources of authority available to the courts and the creditor in determining what must be disclosed under the Act: 1) the Act itself, 2) Regulation Z, 3) the Board's formal interpretations of Regulation Z, and 4) the Federal Reserve Board staff opinion letters. For a discussion of the relative weight to be accorded the latter three sources, *see* St. Germain v. Bank of Hawaii, [1976] 5 CONS. CRED. GUIDE (CCH) ¶ 98,434, at 87,861–62 (D. Hawaii Apr. 12, 1976). Although none of these three sources are absolutely binding upon a court, they are nonetheless entitled to great weight in construing the Act. *See* Philbeck v. Timmers Chevrolet, Inc., 499 F.2d 971, 976 (5th Cir. 1974); Frank v. Reserve Consumer Discount Co., 398 F. Supp. 703, 704–05 (W.D. Pa. 1975); Jones v. East Hills Ford Sales, Inc., 398 F. Supp. 402, 403–04 (W.D. Pa. 1975).

16. *See* Truth in Lending Act, §§ 121(a), 127, 128, 129, 15 U.S.C. §§ 1631(a), 1637, 1638, 1639 (1970); Regulation Z, 12 C.F.R. §§ 226.7, 226.8 (1976).

disclosure of "default, delinquency, or similar charges,"[17] most of these courts have focused upon whether an acceleration clause constituted a "charge" within the meaning of this phrase. The results have been inconsistent, however, since some courts have interpreted "charges" to mean *any* pecuniary burden or expense,[18] while others have limited the term's scope to include only monetary sums imposed in addition to the immediate payment obligation.[19] Alternatively, some courts have focused almost entirely upon whether the purpose of the Act requires disclosure of an

17. *See* notes 6 & 7 *supra*.

18. *See* Meyers v. Clearfield Dodge Sales, Inc., 384 F. Supp. 722, 726–27 (E.D. La. 1974), *rev'd*, 539 F.2d 511 (5th Cir. 1976); Barksdale v. Peoples Financial Corp., [1976] 5 CONS. CRED. GUIDE (CCH) ¶ 98,738, at 88,341 (N.D. Ga. Sept. 5, 1974) (recommendations of special master), *rev'd sub nom.*, McDaniel v. Fulton Nat'l Bank, 543 F.2d 568 (5th Cir. 1976); Pollock v. Avco Financial Servs., [1976] 5 CONS. CRED. GUIDE (CCH) ¶ 98,766, at 88,396 (N.D. Ga. July 1, 1974) (recommendations of special master); Garza v. Chicago Health Clubs, Inc., 347 F. Supp. 955, 959 (N.D. Ill. 1972); *cf.* Hall v. Sheraton Galleries, [1976] 5 CONS. CRED. GUIDE (CCH) ¶ 98,737 (N.D. Ga. Mar. 21, 1974) (recommendations of special master) (disclosure of acceleration clauses necessary in open end as well as closed end credit transactions).

The leading case employing this rationale is *Garza*. The court in *Garza* noted that the word "charge" was defined by Black's Law Dictionary as an "obligation" or "claim" (*see* BLACK'S LAW DICTIONARY 294 (4th ed. 1968)), and that the term had been judicially defined in a pre-Truth in Lending Act case as a pecuniary burden or expense. 347 F. Supp. at 959, *citing* Sunderland v. Day, 12 Ill. 2d 50, 52, 145 N.E.2d 39, 40 (1957). Considering these definitions and the purpose of the Act, the *Garza* court concluded that the acceleration of the balance of the debt was a charge that should be disclosed under section 128(a)(9) of the Act and section 226.8(b)(4) of Regulation Z. 347 F. Supp. at 959. This rationale was also adopted by the district court in *Johnson*. *See* note 9 *supra*.

The *Myers* court also interpreted the term "charge" broadly by holding that it could mean "any pecuniary burden, expense, or obligation." 384 F. Supp. at 727.

19. *See* Allen v. City Dodge, Inc., Civ. No. 74–427A (N.D. Ga. Sept. 8, 1975) (recommendations of special master) (opinion digested in [1976] 5 CONS. CRED. GUIDE (CCH) ¶98,428); McDaniel v. Fulton Nat'l Bank, 395 F. Supp. 422, 427–28 (N.D. Ga. (1975), *rev'd*, 543 F.2d 568 (5th Cir. 1976); Brooks v. Stone Mountain Ford, Inc., Civ. No. 74–231A (N.D. Ga. Mar. 31, 1975) (recommendations of special master) (opinion digested in [1976] 5 CONS. CRED. GUIDE (CCH) ¶ 98,554); McKinney v. Greenbriar Lincoln-Mercury, Inc., Civ. No. 74–1509A (N.D. Ga. Mar. 24, 1975) (opinion digested in [1976] 5 CONS. CRED. GUIDE (CCH) ¶ 98,552); Barrett v. Vernie Jones Ford, Inc., 395 F. Supp. 904, 908 (N.D. Ga. 1975), *rev'd sub nom.*, McDaniel v. Fulton Nat'l Bank, 543 F.2d 568 (5th Cir. 1976); Barksdale v. Peoples Financial Corp., 393 F. Supp. 112, 114–15 (N.D. Ga. 1975), *rev'd sub nom.*, McDaniel v. Fulton Nat'l Bank, 543 F.2d 568 (5th Cir. 1976); Grant v. Imperial Motors, Civ. No. 3146 (S.D. Ga. Dec. 5, 1974) (opinion digested in [1976] 5 CONS. CRED. GUIDE (CCH) ¶ 98,620), *rev'd*, 539 F.2d 506 (5th Cir. 1976); Hamlet v. Beneficial Fin. Co., Civ. No. 74–821A (N.D. Ga. Nov. 4, 1974) (recommendations of special master) (opinion digested in [1976] 5 CONS. CRED. GUIDE (CCH) ¶ 95,646); Pugh v. American Tractor Trailer Training, Inc., Civ. No. 14,109 (D. Conn. Apr. 10, 1974) (opinion digested in [1976] 5 CONS. CRED. GUIDE (CCH) ¶ 98,827); Washington Motor Sales v. Ferreira, 131 N.J. Super. 328, 333–34, 329 A.2d 599, 603 (1974).

When applying this interpretation to an acceleration clause, the courts have had to determine whether the creditor was required to rebate any unearned interest or finance charge upon acceleration. In those cases where the creditor had the right to accelerate the unearned finance charge, the courts have held that this unearned interest constituted an additional charge and that the acceleration clause should have been disclosed. *See* Allen v. City Dodge, Inc., *supra*; McDaniel v. Fulton Nat'l Bank, *supra* at 427–28; Barrett v. Vernie Jones Ford, Inc., *supra* at 908; Pugh v. American Tractor Trailer Training, Inc., *supra*. *See also* Galie, *supra* note 6. On the other hand, in those cases where the creditor was required to rebate the unearned portion of the/

acceleration clause, but again conflicting decisions have resulted.[20] Because of these inconsistencies in the decisional law,[21] both the consumer and the creditor have been unable to ascertain their rights and responsibilities under the Act.[22]

Against this conflicting and inconsistent background, the Third Circuit became the first federal appellate court to deal with the issue.[23] Observing that prior to the enactment of the Act the terms "default charges" and "delinquency charges" had "well established meanings in the commercial credit field and in other consumer credit legislation,"[24] the Third Circuit

finance charge upon acceleration, the courts have concluded that there was no "charge" in addition to that which was already due and, hence, no need to disclose the acceleration clause as a "default, delinquency, or similar charge." *See* Brooks v. Stone Mountain Ford, Inc., *supra*; McKinney v. Greenbriar Lincoln-Mercury, Inc., *supra*; Barksdale v. Peoples Financial Corp., *supra* at 114–15; Grant v. Imperial Motors, *supra*; Hamlet v. Beneficial Fin. Co., *supra*.

20. E.g., Woods v. Beneficial Fin. Co., 395 F. Supp. 9, 16 (D. Ore. 1975) (creditor must disclose any right of acceleration in order to comply with the "meaningful disclosure" standard of the Act); *see* Garza v. Chicago Health Clubs, Inc., 347 F. Supp. 955, 959 (N.D. Ill. 1972). *But see* Houston v. Atlanta Fed. Sav. & Loan Ass'n, Civ. No. 74–119A (N.D. Ga. Sept. 24, 1974) (recommendations of special master) (opinion digested in [1976] 5 CONS. CRED. GUIDE (CCH) ¶ 98,687); *cf.* Stavrides v. Mellon Nat'l Bank & Trust Co., 353 F. Supp. 1072, 1079 (W.D. Pa.), *aff'd*, 487 F.2d 953 (3d Cir. 1973) (broad purpose of Act does not overrule specific language of section 129).

21. To further complicate the situation, one court has rejected the rationales of the other courts, suggesting still another approach for resolving the acceleration clause problem. *See* Morris v. First Nat'l Bank, [1976] 5 CONS. CRED. GUIDE (CCH) ¶ 98,568 (N.D. Ga. July 1, 1975) (recommendations of special master). In *Morris*, the court dealt with section 226.6(g) of Regulation Z which provides: "If information disclosed in accordance with this part is subsequently rendered inaccurate as the result of any act, occurrence, or agreement subsequent to the delivery of the required disclosures, the inaccuracy resulting therefrom does not constitute a violation of this part." 12 C.F.R. § 226.6(g) (1976). This provision also appears in section 124 of the Act. 15 U.S.C. § 1634 (1970). The footnote to section 226.6(g) provides in pertinent part: "Such acts, occurrences, or agreements include the failure of the customer to perform his obligations under the contract and such actions by the creditor as may be proper to protect his interests in such circumstances." 12 C.F.R. § 226.6(g) n.6 (1976). In light of section 226.6(g) and its explanatory footnote, the court held that where the inaccuracy in the disclosed percentage rate results from the subsequent occurrence of default, and the creditor then exercises his right to accelerate, there is no violation of the Act or of Regulation Z, even though the acceleration includes unearned interest. [1976] 5 CONS. CRED. GUIDE (CCH) ¶ 98,568, at 88,074.

22. For an analysis of the judicial inconsistency on this and other issues under the Act and the effects upon consumers and creditors, *see* Paer, *Truth in Lending: Protection for the Consumer or for the Creditor?*, 24 EMORY L.J. 357, 359–68, 377–78 (1975); Rumsey, *Truth in Lending: Congress Reacts to the Creditor's Dilemma*, 24 EMORY L.J. 379, 380–91 (1975).

23. Emphasizing that it was not confronted with the question of whether the Act or Regulation Z requires disclosure of an acceleration clause under which the creditor is not required to rebate the unearned finance charge, the Third Circuit restricted its holding accordingly. 527 F.2d at 260 n.3.

Subsequent to the Third Circuit's decision, the Fifth Circuit has also considered the question presented here. *See* note 46 *infra*.

24. 527 F.2d at 266. The court analyzed two sources in particular to determine the "well established meanings" of the terms. The court first noted that the *Consumer Credit Guide* defines "delinquency charges" as follows:

> "[T]he compensation a creditor receives on a precomputed contract for the debtor's delay in making timely installment payments. . . .
>
> . . . .
>
> Because a precomputed contract is the only one prepared on the assumption that the debtor will make all payments when due, the creditor is left without any

criticized the reasoning of the district court in *Johnson* because it focused only upon the word "charges" and because it emphasized that word's dictionary meaning rather than its well-established meaning in the commercial credit field.[25] The Third Circuit pointed out that the terms "default charges" and "delinquency charges" generally refer to specific monetary penalties which the borrower is required to pay because of his failure to meet the payment schedule.[26] Applying these definitions to the phrase "default, delinquency, and similar charges," the court concluded that section 128(a)(9) required disclosure only of those specific monetary amounts, over and above the amounts already due under the loan, that are imposed because of the untimely payment of one or more installments.[27] Thus, the Third Circuit found that a right of acceleration under which the creditor must rebate the unearned portion of the finance charge is not within the disclosure requirement required of section 128(a)(9) since the rebate

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income for a period where payment is delayed. *In lieu of accelerating the maturity of the entire obligation,* the creditor may make an appropriate charge just for the delay on the particular installment."

Id., *quoting* [1976] 1 CONS. CRED. GUIDE (CCH) ¶¶4230, 4231 (1971) (emphasis supplied by the court). The other source was the Pennsylvania Motor Vehicle Sales Finance Act which defines "default charges" as follows:

"A default charge may be collected on any installment payment or payments which are not paid on or before the due date of such payments. Such default charge shall not exceed the rate of two percent (2%) per month on the amount of the payment or payments in arrears . . . . *Such default charge shall not be collected on any payment in default because of any acceleration provision in the contract.*"

527 F.2d at 266, *quoting* Pennsylvania Motor Vehicle Sales Finance Act, § 21(a), PA. STAT. ANN. tit. 69, § 621(A) (Purdon 1965) (emphasis supplied by the court). *See also* Uniform Consumer Credit Code, § 2.203 [1976] 1 CONS. CRED. GUIDE (CCH) ¶ 5063 (delinquency charge is a charge on an installment not paid in full within a specified period of time after its scheduled due date).

25. 527 F.2d at 265. The Third Circuit specifically noted that the district court ignored the well-established principle of statutory construction, *noscitur a sociis. Id.* at 265 & n.14, *citing* Jarecki v. G.D. Searle & Co., 367 U.S. 303, 307 (1961). This principle is fully defined in 2 J. SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION § 4908 (3d ed. 1943):

In case the legislative intent is not clear, the meaning of doubtful words may be determined by reference to their association with other associated words and phrases. Thus, when two or more words are grouped together, and ordinarily have a similar meaning, but are not equally comprehensive, the general word will be limited and qualified by the special word. But this is so, only if the result is consistent with the legislative intent, for the maxim *noscitur a sociis* is a mere guide to legislative intent.

Id. (footnotes omitted).

The court also indicated its belief that Congress intended to ascribe to the terms "default charges" and "delinquency charges" their ordinary meanings in the consumer credit industry. 527 F.2d at 265–66, *citing* Corning Glass Works v. Brennan, 417 U.S. 182, 201–02 (1974) (where Congress uses technical terms, it is proper to explain them by reference to the field to which they are appropriate). The court recognized that neither the Act nor its legislative history defines the phrase "default, delinquency, or similar charge." 527 F.2d at 265. However, the court also recognized that "the legislative history of the Act indicates that Congress intended to enact remedies that reflected commercial realities." *Id.*, *citing* Stavrides v. Mellon Nat'l Bank & Trust Co., 353 F. Supp. 1072, 1078–79 (W.D. Pa.), *aff'd,* 487 F.2d 953 (3d Cir. 1973); S. REP. No. 392, 90th Cong., 1st Sess. 1–2 (1967).

26. 527 F.2d at 266.

27. *Id.*

prevents the creditor from collecting any *additional* charge.[28] Moreover, since the shortening of the repayment period does not, in itself, constitute a "tangible pecuniary sum assessed because of . . . default,"[29] the fact that it may further burden the borrower or even cause him an additional expense was held to be an insufficient reason to include the acceleration clause within the Act's disclosure requirements.[30]

The plaintiffs additionally argued that the Act had been violated because the contract itself did not provide for a rebate of the unearned interest.[31] The Third Circuit, however, relying upon the principle that statutory provisions of the state in which the contract is executed become a part of the contract,[32] rejected this argument and held that because the

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28. *Id.* The court noted that when a creditor is required to rebate the unearned interest upon acceleration, the result is a shortening of the period within which the principal must be repaid, not the assessment of an additional charge. *Id.*, *citing* Morris v. First Nat'l Bank, [1976] 5 CONS. CRED. GUIDE (CCH) ¶ 98,568 (N.D. Ga. July 1, 1975) (recommendations of special master). The court further asserted that the credit consumer incurs no cost other than that disclosed on the face of the loan contract. The creditor is simply given the right to pursue his remedies against the defaulting debtor immediately, rather than having to wait for the contract term to expire. 527 F.2d at 266, *citing* McDaniel v. Fulton Nat'l Bank, [1976] 5 CONS. CRED. GUIDE (CCH) ¶ 98,683, at 88,263 (N.D. Ga. Sept. 19, 1974) (recommendations of special master), *rev'd*, 543 F.2d 568 (5th Cir. 1976).

29. 527 F.2d at 267.

30. *Id.* The court believed its conclusion was further supported by both the language of section 226.8(b)(4) of Regulation Z (*see* note 7 *supra*) and by Federal Reserve Board Staff Opinion Letter No. 851, [1976] 5 CONS. CRED. GUIDE (CCH) ¶ 31,173 (Oct. 22, 1974), which provides in pertinent part:

> If under the acceleration provision, a rebate is made by the creditor in accordance with the disclosure of the rebate provisions of § 226.8(b)(7), we believe that there is no *additional* "charge" for late payments made by the customer and therefore no need to disclose under the provisions of § 226.8(b)(4). On the other hand, if upon acceleration of the unpaid remainder of the total of payments, the creditor does not rebate unearned finance charges in accordance with the rebate provisions disclosed in § 226.8(b)(7), any amounts retained beyond those which would have been rebated under the disclosed rebate provisions represent a "charge" which should be disclosed under § 226.8(b)(4).

Id. The court, recognizing that the interpretation was that of the Federal Reserve Board staff and not that of the Board itself, noted that "[s]taff opinions are to be considered the opinion of the Board until it rules to the contrary," 527 F.2d at 267 n.23, *citing* Philbeck v. Timmers Chevrolet, Inc., 499 F.2d 971, 976 (5th Cir. 1974) (staff opinion letters, though not binding, are entitled to great weight), *and* Federal Reserve Board Staff Opinion Letter No. 444, [1969–1974 Transfer Binder] CONS. CRED. GUIDE (CCH) ¶ 30,640 (Mar. 1, 1974). It is interesting to note, as did the *Johnson* court, that the Staff Opinion Letter was issued subsequent to the district court opinion in the instant case. 527 F.2d at 267.

In light of the staff opinion letter and its own interpretation of the phrase "default, delinquency, and similar charges," the court refused to adopt plaintiffs' argument that the purpose of the Act required disclosure of the creditor's right of acceleration where unearned interest charges must be rebated. *Id.* at 269. The court noted that "no matter now [*sic*] desirable" general disclosure of acceleration clauses might be, its discussion was necessarily limited to whether the specific provisions of the Act or Regulation Z required such disclosure. *Id.*

31. 527 F.2d at 268.

32. *Id.*, *citing* Von Hoffman v. City of Quincy, 71 U.S. (4 Wall.) 535, 550 (1866). In *Von Hoffman*, the Supreme Court stated a general rule that "the laws which subsist at the time and place of the making of a contract, and where it is to be performed, enter into and form a part of it, as if they were expressly referred to or incorporated in

Pennsylvania Motor Vehicle Sales Finance Act requires the rebate of the unearned finance charge,[33] the failure of the defendants specifically to provide for a rebate in the contract did not warrant a finding that the Act had been violated.[34]

The pivotal question confronted by the *Johnson* court was the interpretation to be given the phrase "default, delinquency, or similar charges." Although the court's ultimate interpretation may be sound and convincing, it nonetheless may have shortchanged the meaning of the phrase by concentrating primarily upon the terms "default charge" and "delinquency charge," and by thereafter narrowly defining a "similar charge" as one which necessarily involves an additional monetary sum.[35] A liberal interpretation[36] by the court of the term "similar" could have resulted in providing the consumer with meaningful disclosure while at the same time doing no damage to the well-established meanings of "default charge"

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its terms." 71 U.S. (4 Wall.) at 550; *accord,* Farmers & Merchants Bank v. Federal Res. Bank, 262 U.S. 649, 660 (1923); N.C. Freed Co. v. Board of Governors, 473 F.2d 1210, 1215 (2d Cir.), *cert. denied,* 414 U.S. 827 (1973); Gardner & North Roofing & Siding Corp. v. Board of Governors, 464 F.2d 838, 841–42 (D.C. Cir. 1972).

33. Pennsylvania Motor Vehicle Sales Finance Act, § 22(B), PA. STAT. ANN. tit. 69, § 622(B) (Purdon 1965). Section 22(B) provides in pertinent part: "Whenever all the time balance is liquidated prior to maturity by prepayment, refinancing, or termination by surrender or repossession and resale of the motor vehicle, the holder of the installment sale contract shall rebate to the buyer immediately the unearned portion of the finance charge." *Id.*

34. 527 F.2d at 268–69. The court also concluded that the method of rebate of the unearned finance charge was properly disclosed pursuant to section 226.8(b)(7) of Regulation Z. *Id.* at 268–69 & n.28. Section 226.8(b)(7) provides in pertinent part:

> In any transaction subject to this section, the following items, as applicable, shall be disclosed.
>
> . . . .
>
> (7) Identification of the method of computing any unearned portion of the finance charge in the event of prepayment in full . . . and a statement of the amount or method of computation of any charge that may be deducted from the amount of any rebate of such unearned finance charge that will be credited to an obligation or refunded to the customer . . . .

12 C.F.R. § 226.8(b)(7) (1976). Since the court considered acceleration to be essentially a prepayment and since the method for rebate upon acceleration was identical to that of voluntary prepayment, the court determined that it was unnecessary to include a separate provision indicating the method of rebate in the event of acceleration. 527 F.2d at 269 n.28. In other words, the disclosure of the method of rebate upon prepayment was sufficient. *See* Federal Reserve Board Staff Opinion Letter No. 851, [1976] 5 CONS. CRED. GUIDE (CCH) ¶ 31,173 (Oct. 22, 1974). *But see* Morris v. First Nat'l Bank, [1976] 5 CONS. CRED. GUIDE (CCH) ¶ 98,568, at 88,072 (N.D. Ga. July 1, 1975) (recommendations of special master) (there is a difference between "prepayment in full," as used in section 226.8(b)(7), and acceleration); Houston v. Atlanta Fed. Sav. & Loan Ass'n, Civ. No. 74–119A (N.D. Ga. Mar. 25, 1975) (recommendations of special master) (opinion digested in [1976] 5 CONS. CRED. GUIDE (CCH) ¶ 98,553) (section 226.8(b)(7) does not require disclosure of rebate method in event of acceleration); Garza v. Chicago Health Clubs, Inc., 347 F. Supp. 955, 959 (N.D. Ill. 1972) (section 226.8(b)(7)'s "prepayment in full" language applied only to voluntary prepayment, and does not encompass involuntary prepayment under an acceleration clause).

35. *See* notes 24–27 and accompanying text *supra.*

36. A strict interpretation refuses to extend the import of words used in a statute so as to include cases or acts which the words do not clearly describe. On the other hand, a liberal interpretation construes the words in an effort to accomplish the purpose or intention of the act. *See* 3 J. SUTHERLAND, *supra* note 25, § 5504.

and "delinquency charge."[37] Instead of focusing upon the common element in those terms as being an assessment of an additional monetary sum, the court, in its statutory analysis, could have determined that a "similar charge," like a "default charge" and a "delinquency charge," is simply one that invokes a penalty for failure to make timely payments.[38] Viewed in this light, the acceleration clause would have to be disclosed under the Act, since such a clause requires the debtor who has failed to make timely payments to pay the entire sum owed, which is more than he would otherwise have to pay at that time. Such a liberal interpretation would comply with the requirement of meaningful disclosure as well as the more specific language of section 128(a)(9) of the Act and section 226.8(b)(4) of Regulation Z.[39]

Notwithstanding the need for liberal construction in the Truth in Lending area,[40] it is submitted that ultimately the *Johnson* court's conclusion may prove to be the better one. If the Act is continually interpreted in a loose and liberal fashion and more disclosures are required, the function of the disclosure statement, if not the purpose of the Act itself, will be totally frustrated. In other words, the result will be a disclosure statement almost as long and confusing as the contract itself.[41]

Another aspect of the court's decision worthy of attention concerns the Third Circuit's rejection of the argument that disclosure should be required when the contract itself makes no mention of the fact that the unearned interest must be rebated under state law.[42] Previously, a few federal district courts had been receptive to such an argument, reasoning that a creditor who asserts a right to collect unearned interest by not expressly providing for a rebate should bear the burden of properly disclosing its existence or be subjected to damages for violating the Act. The fact that the lender would be unable to enforce that right under state law was deemed irrelevant by these

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37. Certainly, no statutory interpretation should do violence to any of the words being defined. *See* 2 J. SUTHERLAND, *supra* note 25, § 4706; 3 *id.* § 5504. However, a statute should be construed with reference to its manifest intention, and if the language is susceptible of two meanings, one which will execute the purpose of the statute and the other which will defeat it, the language should be given the former construction. *See* 2 *id.* § 4704. *See also* N.C. Freed Co. v. Board of Governors, 473 F.2d 1210, 1214 (2d Cir.), *cert. denied,* 414 U.S. 827 (1973) (Act's terms must be construed in liberal fashion if underlying congressional purpose is to be effectuated).

38. For the definitions of "default charge" and "delinquency charge" relied upon by the *Johnson* court, *see* note 24 *supra.*

39. *See* note 13 and accompanying text *supra.* It is important to note that this interpretation does not rely solely upon the purpose of the Act, which was the basis of the court's decision in Woods v. Beneficial Fin. Co., 395 F. Supp. 9, 16 (D. Ore. 1975). In *Woods,* the court did not rest its conclusion upon a specific section of the Act or Regulation Z. Rather, it held that the "meaningful disclosure" standard of the Act alone requires disclosure of an accelerating clause. *Id.* Unlike the *Woods* analysis, the proposed interpretation attempts to define the language of section 128(a)(9) of the Act and section 226.8(b)(4) of Regulation Z *in light of* the intention of the Act.

40. *See* N.C. Freed Co. v. Board of Governors, 473 F.2d 1210, 1214 (2d Cir.), *cert. denied,* 414 U.S. 827 (1973).

41. This problem may have already presented itself. *See Hearings on the Consumer Protection Efforts of the Three Major Bank Regulatory Agencies Before the Senate Comm. on Banking, Housing and Currency,* 94th Cong., 2d Sess. 119–20 (1976) (Statement of Jonathan Landers).

42. *See* notes 31–34 and accompanying text *supra.*

courts.[43] Although not discussed by the *Johnson* court, the main difficulty with this rationale is that it appears to be supported primarily, if not entirely, by the "policy" of the Truth in Lending Act.[44] The Third Circuit was obviously not impressed with this policy argument since it disposed of it simply by asserting a "general rule" that the laws "of the state in which the contract is executed or performed become part o the contract."[45]

In light of *Johnson* and the fact that the Truth in Lending Act does not mention acceleration clauses, the arguments which the district courts prior to *Johnson* have accepted in concluding that disclosure is required, though imaginative, must be deemed tenuous at best. Indeed, these arguments may have been dealt their death blow by a recent Fifth Circuit opinion which supports the conclusion if not the reasoning of the Third Circuit in *Johnson*.[46]

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43. *See* McDaniel v. Fulton Nat'l Bank, 395 F. Supp. 422, 427–28 (N.D. Ga. 1975), *rev'd*, 543 F.2d 568 (5th Cir. 1976); Barrett v. Vernie Jones Ford, Inc., 395 F. Supp. 904, 908–09 (N.D. Ga. 1975), *rev'd sub nom.*, McDaniel v. Fulton Nat'l Bank, 543 F.2d 568 (5th Cir. 1976).

One commentator has suggested several reasons for holding that an acceleration clause, which does not itself provide for a rebate of the unearned finance charge, should be disclosed even if state law requires such a rebate. Galie, *supra* note 6, at 331–34. One reason is that such a required disclosure would encourage creditors to draft their agreements in conformity with state law. *Id.* at 331–32. Creditors would have a choice of including in the acceleration clause a provision stating that any unearned interest will be rebated upon acceleration (which state law requires anyway), or disclosing that they assert a right to collect the unearned interest (which state law prohibits). By choosing the latter course, creditors would aid in the detection of violations of state law. *Id.* at 332. A second reason is that since borrowers may not know that the collection of the unearned finance charge is prohibited by state law, they may pay it if it is not disclosed. *Id.* Hence, by putting creditors to the choice described above, the possibility of unwary borrowers being deceived into paying the unearned finance charges upon acceleration will be reduced. *Id.* at 332–33. A third reason offered by the commentator is that Congress never intended that the Act's disclosure requirements be nullified or modified by state law. *Id.* at 333–34.

44. In McDaniel v. Fulton Nat'l Bank, 395 F. Supp. 422 (N.D. Ga. 1975), *rev'd*, 543 F.2d 568 (5th Cir. 1976), the district court stated:

> [T]he effectuation of the Congressional purpose as set out in 15 U.S.C. § 1601 requires disclosure of all charges which the lender asserts a right to collect at the time credit is extended whether or not it is finally determined that he can utilize the enforcement mechanisms of the state courts to collect the charge.

395 F. Supp. at 428.

45. 527 F.2d at 268. Even recognizing the applicability of this "general rule," it may be that a court, when faced with this issue, will undertake to explore the relevant state law and not feel itself bound by any conclusions reached in *Johnson*. This indeed was the situation in Burley v. Bastrop Loan Co., 407 F. Supp. 773 (W.D. La. 1976) (supplemental opinion), which held that the nondisclosure of an acceleration clause violated section 226.8(b)(4) of Regulation Z. In *Burley*, the court analyzed the Louisiana law which required that there be a rebate upon acceleration. The court found that the rebate under the state law was conditioned upon the creditor bringing suit to collect the obligation, whereas the Pennsylvania law involved in *Johnson* did not require the creditor to file suit in order to collect the unpaid principal. *Id.* at 780–81. Thus, the creditor in *Burley* had the *power* to collect as yet unearned interest, even though it did not have the *right* to do so. *Id.* at 781. The *Burley* court also concluded that the disclosure of an acceleration clause lies within the expressed congressional purpose of the Act. *Id.* at 792.

46. Martin v. Commercial Sec. Co., 539 F.2d 521 (5th Cir. 1976). In *Martin*, the Fifth Circuit accepted the *Johnson* court's conclusion that section 128(a)(9) of the Act requires "disclosure only of those specific monetary sums imposed upon the debtor because of the late payment of an installment." *Id.* at 528. Unlike the Third Circuit,

It is nevertheless both interesting and noteworthy that in the absence of appellate court guidance, so many federal district courts, purportedly relying on the "policy" of the Truth in Lending Act, have required disclosure of acceleration clauses even when state law required the rebate of unearned interest charges. It does not take a great deal of insight to imply from these opinions that the courts had, if nothing else, been persuaded that the consumer would benefit greatly from a disclosure of the acceleration clause. It was therefore not necessarily such a large step for these courts to conclude that such disclosure *should* be within the scope of the Truth in Lending Act if it was not already.[47] Given this assumption, it seems likely that unless Congress enacts amending legislation in this area, the decisions of the Third and Fifth Circuits may serve only to force consumer litigants and the courts so disposed to find other sections in the Act through which to imply a requirement that acceleration clauses be disclosed.

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however, the Fifth Circuit refused to place reliance upon the Federal Reserve Board Staff Opinion Letter. *See* note 30 *supra*. The Fifth Circuit believed that the staff's conclusion that acceleration is basically a prepayment of the contract obligation was without foundation for "[i]n the installment credit context prepayment and acceleration appear to be conceptually antithetical." 539 F.2d at 529. Hence, the *Martin* court, refusing to find section 226.8(b)(7) of Regulation Z applicable to acceleration, rejected the borrower's argument that the creditor's asserted right to collect any unearned interest upon acceleration is a charge required to be disclosed under section 128(a)(9), holding that "in the absence of a regulation requiring it, failure to disclose an acceleration clause and the lender's rebate policy with respect thereto in an installment credit transaction does not give rise to a claim for statutory damages." *Id.* This holding has been adopted by the Fifth Circuit in other recent opinions. *See* McDaniel v. Fulton Nat'l Bank, 543 F.2d 568, 569–70 (5th Cir. 1976); Grant v. Imperial Motors, 539 F.2d 506, 508 (5th Cir. 1976); Meyers v. Clearfield Dodge Sales, Inc., 539 F.2d 511, 519 (5th Cir. 1976).

It is important to note that the Fifth Circuit in *Martin* appeared to be impressed with the fact that there was no mention of acceleration clauses in the Act, Regulation Z, or the Federal Reserve Board's formal interpretations, even though such clauses were often seen in installment contracts. 539 F.2d at 524.

47. The *Johnson* court, on the other hand, was unwilling to take that step. It stated:

> It may indeed be true, as plaintiffs argue, that some borrowers do not know that a creditor can require the entire debt to be due upon default, or that other consequences may flow from default. However, no matter now [*sic*] desirable we might think it to underscore a creditor's right to accelerate payment upon default, the question to which we are, of course, limited is whether the specific provisions of the Truth in Lending Act or Regulation Z require inclusion of this significant right in the disclosure statement.

527 F.2d at 269 (footnote omitted).

ADMINISTRATIVE LAW — INTERSTATE COMMERCE ACT — INTERSTATE COMMERCE COMMISSION POSSESSES STATUTORY AND CONSTITUTIONAL AUTHORITY TO DENY RENT TO RAIL CARRIER FOR USE OF ITS LINES DURING A DIRECTED SERVICE.

Lehigh & New England Railway v. ICC (1976)

The Lehigh and New England Railway Company (L & NE), a railroad carrier located solely in Pennsylvania, experienced three consecutive years of deficit operations as of December 1974.[1] Faced with a projection of continued losses in 1975, L & NE issued an embargo, effective January 24, 1975, encompassing all traffic moving to, from, and over its lines.[2] In order to prevent the implementation of L & NE's proposed embargo,[3] the Interstate Commerce Commission (ICC), pursuant to section 1(16)(b) of the Interstate Commerce Act (ICA),[4] issued Service Orders 1207 and 1208 on

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1. Lehigh & N.E. Ry. v. ICC, 540 F.2d 71, 76 (3d Cir. 1976). L & NE experienced a substantial decline in net income in 1972, and it was operating at an annual deficit in excess of $100,000 in 1973 and 1974. *Id.* This financial difficulty was attributed to a decrease in coal and cement traffic over its lines. *Id.*

2. *Id.* The decision to issue an embargo was prompted by an operating loss projection totalling nearly $400,000 for the first six months of 1975. *Id.*

3. The potential disruption of rail service that this type of embargo could cause was forecasted by the Interstate Commerce Commission (ICC) in a report to the United States Committee on Commerce on a proposed amendment to section 1(16) of the Interstate Commerce Act (ICA), 49 U.S.C. § 1(16) (1970). S. REP. NO. 302, 93d Cong., 1st Sess. 7 (1973) [hereinafter cited as S. REP. NO. 302]. The ICC stated: "[T]he nation's railroads operate as an integrated system, notwithstanding the fact that the system consists of many individual enterprises. . . . If one operation terminates because of some crisis, the effect will ripple throughout the entire system." *Id.*

4. 49 U.S.C. § 1(16)(b) (Supp. V 1975). Section 1(16)(b) provides in relevant part:

> (b) Whenever any carrier by railroad is unable to transport the traffic offered it because—
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> (1) its cash position makes its continuing operation impossible;
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> (2) it has been ordered to discontinue any service by a court; or
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> (3) it has abandoned service without obtaining a certificate from the Commission pursuant to this section;
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> the Commission may . . . make such just and reasonable directions with respect to the handling, routing, and movement of the traffic available to such carrier and its distribution over such carrier's lines, as in the opinion of the Commission will best promote the service in the interest of the public and the commerce of the people subject to the following conditions:
>
> . . . .
>
> (E) Any order of the Commission entered pursuant to this paragraph shall provide that if, for the period of its effectiveness, the cost, as hereinafter defined, of handling, routing, and moving the traffic of another carrier over the other carrier's lines of road shall exceed the direct revenues therefor, then upon request, payment shall be made to the directed carrier, in the manner hereinafter provided and within 90 days after expiration of such order, of a sum equal to the amount by which such costs has exceeded said revenues. The term "cost" shall mean those expenditures made or incurred in or attributable to the operations as directed, including the rental or lease of necessary equipment, plus an appropriate allocation of common expenses, overheads, and a reasonable profit. Such cost shall be then currently recorded by the carrier or carriers in such manner and on such forms as by general order may be prescribed by the Commission and shall be submitted to and subject to audit by the Commission. The Commission shall certify promptly to the Secretary of the Treasury the amount of payment to be made to said carrier or carriers under the provisions of this paragraph. Payments

January 17, 1975.[5] As subsequently revised, the orders directed the Lehigh Valley Railroad Company (LVRR) and the Reading Company (Reading) to operate over L & NE's lines for 240 days beginning January 24, 1975, and further required LVRR, Reading, and L&NE to negotiate an agreement concerning the directed operation.[6] During the negotiations L & NE contended that it was entitled to receive rent for the use of its facilities during the period of directed service, maintaining that rent would be a reimbursable cost to the directed carrier under section 1(16)(b)(E) of the ICA.[7] Intervening in the negotiations to resolve this issue,[8] the ICC determined that L & NE had not demonstrated a sufficient basis to support its rent demand.[9] Upon notice of this ICC decision, the negotiations dissolved.[10]

Shortly thereafter, L&NE petitioned the United States Court of Appeals for the Third Circuit to set aside the ICC's determination of the rent issue, naming the ICC and the United States as respondents.[11] In its

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required to be made to a carrier under the provisions of this paragraph shall be made by the Secretary of the Treasury from funds hereby authorized to be appropriated in such amounts as may be necessary for the purpose of carrying out the provisions hereof.

Id.

The railroad which is ordered by the ICC to provide service over the lines of an nonoperating carrier is referred to as "the directed carrier," the railroad whose lines are being operated by a directed carrier is designated as "the other carrier." Lehigh & N.E. Ry. v. ICC, 540 F.2d 71, 76 (3d Cir. 1976).

5. Service Order No. 1207, 40 Fed. Reg. 4,309 (1975); Service Order No. 1208, *id.* at 4,311. Representatives of L & NE met with the ICC in the latter part of December 1974, after L & NE had received the projections of severe operating losses for the first half of 1975. 540 F.2d at 76. At this meeting L & NE indicated its intention to embargo all traffic to, from, and over its lines in the beginning of 1975. *Id.*

6. Corrected Revised Service Order No. 1207, 40 Fed. Reg. 13,506-07 (1975); Corrected Revised Service Order No. 1208, *id.* at 13,508-09 (1975). The agreement was to embody terms "including, but not limited to use of and rental for equipment, use of and compensation for, existing inventories of fuel, materials, and supplies, and rental for use of rights-of-way and other rail facilities." Corrected Revised Service Order No. 1207, *id.* at 13,506-07; Corrected Revised Service Order 1208, *id.* at 13,508-09. Final approval by the ICC was required in order to validate the agreement reached by the carriers. Corrected Revised Service Order No. 1207, *id.* at 13,506-07; Corrected Revised Service Order No. 1208, *id.* at 13,508-09. The ICC alleged that L & NE requested that a directed service be ordered over its lines; but L & NE denied this allegation. 540 F.2d at 76 & n.15. Thereafter, the ICC conducted meetings with L&NE and L&NE's shippers in an effort to formulate an alternative to directed service. *Id.* at 76. When no solution was forthcoming, the ICC issued Service Orders 1207 and 1208. *Id.*

7. 540 F.2d at 76-77. Section 1(16)(b)(E) defines those expenses of a directed carrier that can be classified as a "cost" of a directed service. *See* 49 U.S.C. § 1(16)(b)(E) (Supp. V 1975). For the text of this section, *see* note 4 *supra.*

8. Corrected Revised Service Orders 1207 and 1208 both provided that in the case of disagreement between the directed carrier and the other carrier on the terms of the agreement, "the directed service shall continue pending a Commission determination to establish such terms as it may find to be just and reasonable. . . ." 40 Fed. Reg. 13,506-07 (1975); *id.* at 13,508-09.

9. 540 F.2d at 77. The total operating losses incurred by LVRR and Reading in conducting the directed service over L & NE's lines amounted to $325,891. *Id.* For a discussion of the ICC's reasons for excluding rent to the other carrier as a reimbursable cost of an unprofitable directed service, *see* note 33 and accompanying text *infra.*

10. 540 F.2d at 77.

11. *Id.* at 72. It should be noted that L & NE instituted the present action to clear the way to file suit in the Court of Claims against the United States for compensation

petition, L & NE alleged, *inter alia*,[12] that the scope of the ICC's order exceeded the statutory authority vested in it by section 1(16)(b) of the ICA[13] and that directed service without payment of rent constituted a taking without just compensation in violation of the fifth amendment.[14] The Third Circuit[15] denied L & NE's request to review and vacate the ICC order, *holding* that the decision to deny rent to L & NE was within the statutory authority granted to the ICC, and that directed service did not constitute a taking for which just compensation was required. *Lehigh & New England Railway Co. v. ICC*, 540 F.2d 71 (3d Cir. 1976).

The taking clause of the fifth amendment of the United States Constitution[16] was designed to compensate citizens for any injury resulting

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for the use of its facilities during the period of directed service. *Id.* at 75 n.12. This suit was originated to prevent a charge by the Court of Claims that L & NE was collaterally attacking the ICC regulation upon which the denial of rent to L & NE was based, 49 C.F.R. § 1126 (1976). 540 F.2d at 75 n.12.

12. L & NE contended that even if the ICC possesses the constitutional and statutory authority to determine which costs incurred by a directed carrier would be reimbursable, the distinction between profitable and unprofitable periods of directed service as the criterion for determining when rent would be classified as a reimbursable cost was arbitrary and capricious. 540 F.2d at 77.

L & NE further claimed that by deciding that the payment of rent would be reimbursable only when the directed operation was profitable, the ICC had usurped the judicial function of determining what constitutes just compensation. *Id.* at 77. Since the court's holding that directed service did not effect a taking eliminated the necessity of establishing the type and nature of compensation due the other carrier, the court concluded that resolution of the usurpation issue was not required. *Id.* at 82 n.22.

13. *Id.* at 77. L & NE alleged that section 1(16)(b) of the ICA does not empower the ICC to determine which costs of a directed service would be reimbursable. *Id.* Rather, L & NE contended that the proper interpretation of section 1(16)(b) authorized the ICC only to prescribe a form for recording the costs incurred by directed carriers during a period of directed service. *Id.* Respondent ICC asserted that its authority under section 1(16)(b) to determine which costs of a directed carrier would be reimbursable was rooted in the preamble to the Rail Act, 45 U.S.C. § 701(a)(6) (Supp. V 1975), and in the ICC's inherent power to regulate the flow of federal funds to the rail industry. 540 F.2d at 77.

14. 540 F.2d at 77. The ICC disputed L & NE's assertion that directed service constituted a taking in contravention of the fifth amendment, claiming that directed service merely fulfilled the other carrier's duty to continue to provide service. *Id.* Moreover, the ICC alleged that the other carrier, L & NE in this case, would receive substantial benefits as a result of a directed operation and that such benefits would be just compensation. *Id.* at 77–78. The ICC also raised two barriers to the institution of the action by L & NE. First, the ICC asserted that L & NE was equitably estopped from attacking the order because L & NE had actively sought and received substantial benefits from the directed operation. *Id.* at 77. Since there was a dispute over whether L & NE had requested the ICC to conduct a directed service over its lines, and a lack of evidence indicating that L & NE was aware, prior to the start of the directed operation, that it would not receive compensation for the use of its facilities, the court concluded that the doctrine of equitable estoppel was not applicable. *Id.* at 78. Second, the ICC maintained that L & NE lacked standing to challenge the allowance of rent during a *profitable* directed service because that situation was hypothetical, as the directed operations in the instant case were *unprofitable*. *Id.* The court rejected this argument, stating the L & NE was "clearly aggrieved" by the application of this distinction and, therefore, had standing to challenge it. *Id.* at 85 n.45.

15. Judge Hunter wrote the opinion, joined by Judges Adams and Garth.

16. The applicable portion of the fifth amendment provides: "[N]or shall private property be taken for public use, without just compensation." U.S. CONST. amend. V.

from governmental interference with their private property.[17] The application of the fifth amendment's compensation requirement traditionally has been dependent upon the determination that the challenged government activity is a taking rather than a legitimate exercise of the government's police power, for which no compensation is due.[18] In making this determination, the courts have been reluctant to articulate any standard. Rather, they have resolved the issue by an appraisal of the individual circumstances of each case.[19] However, one factor which the courts have considered determinative of the existence of a taking has been the government's use or physical invasion of private property.[20]

The instant controversy over payment of rent to L & NE for the use of its facilities during the period of directed service stems from an amendment to section 1(16) of the ICA by section 601(e) of the Regional Rail Reorganization Act of 1973 (Rail Act).[21] Prior to the amendment, the ICC's

17. Michelman, *Property, Utility, and Fairness: Comments on the Ethical Foundations of 'Just Compensation' Law*, 80 HARV. L. REV. 1165, 1165 (1967).

18. Sax, *Takings, Private Property and Public Rights*, 81 YALE L.J. 149, 149 (1971); *see* Mugeler v. Kansas, 123 U.S. 623 (1887). In *Mugeler*, the Supreme Court rejected a brewery owner's challenge that a state regulation prohibiting the sale and manufacture of alcoholic beverages was a taking which required compensation. *Id.* at 668–69. Justice Harlan defined the nature of the police power as "legislation [which] does not disturb the owner in the control or use of his property for lawful purposes, nor restrict his right to dispose of it, but is only a declaration by the State that its use by anyone, for certain forbidden purposes, is prejudicial to the public interests." *Id.* at 669.

19. *See* Goldblatt v. Town of Hempstead, 369 U.S. 590 (1962) (regulation prohibiting excavations below the water table level which deprived petitioner of his mining business held to be a valid exercise of police power); United States v. Caltex, Inc., 344 U.S. 149 (1952) (destruction of respondents' terminal facilities during wartime was a legitimate exercise of police power); Pennsylvania Coal Co. v. Mahon, 260 U.S. 393 (1922) (regulation prohibiting mining which caused surface damage was a taking of mining company's subsurface rights where it had conveyed title to the surface on the condition that it would not be liable for damages resulting from its mining activities); Air Gloves, Inc. v. United States, 420 F.2d 1386 (Ct. Cl. 1970) (seizure of corporation's property in an enemy country during time of war did not constitute a taking).

Commentators have enumerated certain factors influential in answering the question of whether the government activity amounts to a taking. *See* Michelman, *supra* note 17, at 1184, wherein the author lists the following factors:

> (1) whether or not the public or its agents have physically used or occupied something belonging to the claimant; (2) the size of the harm sustained by the claimant or the degree to which his effected property has been devalued; (3) whether the claimant's loss is outweighed by the public's concomitant gain; (4) whether the claimant has sustained any loss apart from restriction of his liberty to conduct some activity considered harmful to other people.

Id.

20. *See* United States v. Dickinson, 331 U.S. 745, 748 (1947) (continuing physical invasion of owner's property by flooding caused by dam constructed by Government held to be a compensable taking); United States v. General Motors Corp., 323 U.S. 373 (1945) (lessee entitled to compensation for the Government's assumption of possession of warehouse during the lease term); Eyherabide v. United States, 345 F.2d 565 (1965) (Government activity on Naval gunnery range, located adjacent to plaintiff's land, deprived plaintiff of use of property, amounting to a taking); Twin Falls Canal Co. v. American Falls Reservoir Dist. No. 2, 45 F.2d 649, (S.D. Idaho 1930) (entry on and use of reservoir and dam warranted compensation); Michelman, *supra* note 17, at 1184, 1228.

21. Pub. L. No. 93–236, Title VI, § 601(e), 87 Stat. 1021 (1973) (*amending* 49 U.S.C. § 1(16) (1970)) (codified at 49 U.S.C. § 1(16)(b) (Supp. V 1975)). The Regional Rail

authority to respond to a cessation of service by a rail carrier was limited to rerouting that railroad's traffic over other carriers' lines.[22] Determining that the most effective way to strengthen the ICC's ability to prevent a disruption of essential rail service was to empower the ICC to direct a carrier (the directed carrier) to operate over the lines of an incapacitated carrier (the other carrier) for an interim period,[23] Congress granted the ICC such authority by amending section 16 of the ICA.[24] This amendment was designed as a temporary measure enabling the ICC to take immediate action to avert a termination of service,[25] and thus preserve rail transportation for the public by precluding the possibility that a cessation of service by one carrier would adversely affect other carriers' abilities to continue service.[26]

While directed service under section 1(16)(b) would preserve rail transportation and the railroad industry, it could also impose formidable burdens upon the directed carrier.[27] In an effort to eliminate any financial hardship to the directed carrier, Congress provided in section 1(16)(b)(E) for the reimbursement of the directed carrier for expenses incurred during the

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Reorganization Act of 1973 (Rail Act) was a comprehensive congressional response to the railroad crisis in the Northeast and Midwest regions of the United States. S. REP. No. 601, 93d Cong., 1st Sess. 1, 6–8 (1973) [hereinafter cited as S. REP. No. 601]. The long-range solution provided in the Rail Act envisioned "a reorganization of the railroads, stripped of excess facilities, into a single, viable system operated by a private, for-profit corporation." Regional Rail Reorganization Act Cases, 419 U.S. 102, 108–09 (1974). However, short term remedies, such as the amendment to section 1(16) of the ICA, were included in order to avoid a disruption of essential service during the development of this unified rail network. S. REP. No. 601, *supra* at 9.

22. This power was originally contained in section 1(16) of the ICA, 49 U.S.C. § 1(16) (1970) (amended 1973). The amendment by the Rail Act denominated this provision section 1(16)(a) and added section 1(16)(b). *See* Pub. L. No. 93–236, Title VI, § 601(e), 87 Stat. 1021 (1973) (*amending* 49 U.S.C. § 1(16) (1970)) (codified at 49 U.S.C. § 1(16)(b) (Supp. V. 1975)). In arguing for the amendment, the ICC maintained that as originally enacted, section 1(16) was not sufficiently expansive to prevent a disruption of rail service: "Particularly in cases where there is no parallel service offered by another rail carrier, the sudden termination of such operations would be a serious blow to many commercial interests and could have serious implications for the health and well-being of the region served by the railroad." *Hearings on S. 2494 Before the Subcomm. on Surface Transportation of the Senate Comm. on Commerce,* 92d Cong., 1st Sess., ser. 43, at 3 (1971).

23. *See* S. REP. No. 601, *supra* note 21, at 10.

24. *See* 49 U.S.C. § 1(16)(b) (Supp. V. 1975). For the text of this section, *see* note 4 *supra.*

25. S. REP. No. 601, *supra* note 21, at 10. The purpose of the amendment was to provide "an interim remedy intended to assist the railroads in maintaining existing essential services while a more long-range plan for reorganization and revitalization is implemented." *Id.*

26. S. REP. No. 302, *supra* note 3, at 7. The ICC described two ways in which section 1(16)(b) would alleviate the potential adverse effects on other rail lines resulting from a termination of service by one carrier: "First, the Commission would be able to prevent a cessation of essential service by directing adjacent or other connecting carriers to conduct operations over a defunct carrier's lines. Secondly, by maintaining such service, the Commission can prevent a chain reaction which otherwise could thrust marginal connecting carriers into bankruptcy." *Id.*

27. For example, section 1(16)(b)(D) requires a directed carrier to assume all the employment obligations of those employees of the other carrier who are retained during the directed service. 49 U.S.C. § 1(16)(b)(D) (Supp. V 1975).

directed operations.[28] Section 1(16)(b)(E) requires the ICC to formulate a method for recording the costs and revenues of a directed service, to prescribe the forms to be used by a directed carrier seeking reimbursement, to audit those forms submitted by the directed carrier for reimbursement, and to certify to the Secretary of the Treasury of the United States the amount of permissible reimbursements payable to the directed carrier.[29]

Pursuant to section 1(16)(b)(E), the ICC instituted a rulemaking proceeding to prepare a report[30] and to promulgate cost form regulations[31] setting forth the forms and guidelines necessary for a directed carrier's claim for reimbursement. The report announced that the ICC's policy would be to limit the reimbursements made to a directed carrier to those expenses "absolutely necessary" to performing the directed service.[32] Specifically, the ICC declared that rent paid by the directed carrier to the other carrier for the use of the latter's facilities during an *unprofitable* period of directed service would not be regarded as a reimbursable cost.[33] L & NE challenged the ICC's statutory and constitutional right to enforce this policy.[34]

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28. *Id.* § 1(16)(b)(E).

29. *Id.* For the text of this section, *see* note 4 *supra.*

30. ICC, IMPLEMENTATION OF PUBLIC LAW 93-236, SECTION 601(e), REGIONAL RAIL REORGANIZATION ACT OF 1973 — SUBMISSION OF COST DATA TO JUSTIFY REIMBURSEMENT, 348 I.C.C. 251 & 320 (1975) [hereinafter cited as ICC REPORT].

31. 49 C.F.R. § 1126 (1976). Section 1126.1 explained the relationship of the ICC REPORT to the regulations:

> The report and order of the Commission . . . should be used by directed carriers for guidance in the preparation of the cost form. This report and its appendix set forth the Commission's policy as to just what costs and revenues incurred in or attributable to the conduct of directed operations, are allowable for purposes of inclusion in the cost form. Only such allowable costs and revenues will be considered by the Commission in its computation of payments due to the directed carrier under the provisions of section 1(16)(b) of the Interstate Commerce Act.

Id. § 1126.1.

32. ICC REPORT, *supra* note 30, at 251, 260. The ICC REPORT stated:

> The emphasis in the legislative discussions of section 1(16)(b) on the temporary nature and profit potential of directed operations indicates to the Commission that guidelines and policies accompanying the general cost form should emphasize limited, short-term expenditures and should make clear to the directed carrier that only expenditures absolutely necessary to the performance of the service will be considered in determining the amount of final payment to the directed carrier.

Id.

33. *Id.* at 251, 265. Two railroads, Central Railroad Company of New Jersey and LVRR, challenged the ICC's position on the rent issue during the proceeding in which the cost reimbursement report and regulations were formulated. *Id.* at 255–56. However, the ICC contended:

> [I]n ordering directed service, the Commission both fulfills the carrier's obligation to continue to provide service and preserve the value that the operated properties might have for continued use in their dedicated purpose.
>
> Accordingly, it is our view that in the usual situation, where costs exceed revenues, no compensation or rent for the use of the defaulting carrier's lines and facilities is required.

Id. at 265. Since a directed carrier would be unwilling to pay rent to the other carrier if this expense was not reimbursable, the practical consequence of the ICC's refusal to reimburse a directed carrier for rent paid to the other carrier during an unprofitable directed service was to deprive the other carrier of compensation for the use of its lines and facilities. 540 F.2d at 75.

34. 540 F.2d at 77; *see* notes 13 & 14 and accompanying text *supra.*

Within this historical context, the court in the instant case examined the petitioner's contentions. Upon analyzing the ICC's express power to audit under section 1(16)(b)(E) of the ICA[35] and the statement of purposes in the preamble of the Rail Act,[36] the Third Circuit concluded that the ICC possessed the implied authority under section 1(16(b) to decide in a reasonable manner which expenses of a directed service would be reimbursable.[37] Having so determined, the court then considered whether, in excluding rent as a permissible cost of an unprofitable directed service, the ICC had properly exercised this authority within the meaning of the ICA and the United States Constitution.[38] In focusing upon the statutory issue,[39] the court accepted the ICC's contention that Congress had not intended to

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35. *See* 540 F.2d at 79, *construing* 49 U.S.C. § 1(16)(b)(E) (Supp. V 1975). The court concluded that the grant of the express power to audit in section 1(16)(b)(E) imposed upon the ICC a duty "to determine that the amounts expended by a directed carrier were the type of expenditures for which Congress intended the carrier to receive reimbursement." 540 F.2d at 79. In so concluding, the court rejected L & NE's interpretation that the authority to audit was limited merely to verifying that the expenses and revenues were actually expended or received by the directed carrier. *Id.* at 77.

36. *See* 540 F.2d at 79, *construing* 45 U.S.C. § 701(a) (Supp. V 1975). Noting that one of the purposes of the Rail Act was to provide the "necessary Federal financial assistance at the lowest possible cost to the general taxpayer," the court maintained that this express congressional aim would be frustrated if a directed carrier were permitted to receive reimbursement for every expenditure made in connection with a directed service, regardless of its reasonableness. 540 F.2d at 79, *quoting* 45 U.S.C. § 701(a)(6) (Supp. V 1975). The court explained that by relying upon the preamble it was not, as L & NE contended, conferring powers upon the ICC which were not contained in section 1(16)(b). 540 F.2d at 79. Rather, the court pointed out that the preamble was being used as a guide to delineate the scope of authority which Congress vested in the ICC by the operative language of section 1(16)(b)(E). *Id.* The court noted that the Supreme Court had utilized the preamble to the ICA in a similar manner. *Id.* at 79–80, *citing* American Trucking Ass'ns v. Atchinson, T. & S.F. Ry., 387 U.S. 397, 409–10 (1967), *and* United States v. Pennsylvania R.R., 323 U.S. 612, 618–19 (1945).

37. 540 F.2d at 78–79. The express power to audit and the purpose of the Rail Act to minimize the federal financial commitment led the court to conclude that "Congress intended that the directed carrier be reimbursed for all reasonable expenses necessary to providing directed service." *Id.* at 80. After noting the broad subject matter and responsibility entrusted to the ICC by the ICA and the Rail Act, the court adopted a policy of generous construction of the ICC's statutory authority. *Id.* Thus, the court's determination of congressional intent coupled with its generous construction of the ICC's statutory authority formed the foundation of the court's holding that the authority to determine which costs of a directed service were reimbursable was implied in section 1(16)(b) of the ICA. *See id.* at 78–80.

38. *See id.* at 80–85.

39. *See id.* at 80. Noting that courts, when reviewing an administrative construction of a statute, have tended to defer to the interpretation of the agency charged with the implementation of the statute, the instant court quoted at length the Supreme Court's position:

> 'When faced with problems of statutory construction, this court shows great deference to the interpretation given the statute by the officers or agency charged with its administration. . . . To sustain the Commission's application of this statutory term, we need not find that its construction is the only reasonable one, or even that it is the result we would have reached had the question arisen in the first instance in judicial proceedings. . . . Particularly is this respect due when the administrative practice at stake involves a contemporaneous construction of a statute by the men charged with the responsibility of setting its machinery in

furnish a monetary incentive to a rail carrier to abandon service prior to the approval of the ICC by providing for the payment of rent during a directed service.[40] Concluding that the ICC's interpretation of section 1(16)(b) with regard to the rent issue was reasonable in light of Congress' intent in enacting that section, the court held that the ICC had properly exercised its statutory authority.[41]

The Third Circuit then considered whether the ICC's determination comported with the United States Constitution — specifically, whether directed service constituted a taking, and whether the ICC's denial of rent deprived the other carrier of just compensation as required by the fifth amendment.[42] The court compared directed service with the ICC's power to order a carrier that has not obtained a certificate of abandonment to continue to provide service.[43] In particular, the court reviewed the *New Haven Inclusion Cases,*[44] in which the United States Supreme Court held that there had been no taking even though the carrier in question had been

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motion, of making the parts work efficiently and smoothly while they are yet untried and new.'

Id., quoting Udall v. Tallman, 380 U.S. 1, 6 (1965) (citations omitted).

40. 540 F.2d at 80–81. In the ICC REPORT the rationale supporting exclusion of rent as a reimbursable cost of an unprofitable directed service was explained:

> Under the Interstate Commerce Act, all common carriers by railroad must fulfill their common carrier obligation to continue service to the public . . . unless and until a certificate of abandonment is authorized by the Commission. . . . Under the requirements of section 1(16)(b), in order for the Commission to issue a directed service order, the operated carrier, having ceased operations without obtaining a certificate of abandonment from the Commission, must be in dereliction of its statutory duty to continue to provide such service. It is highly unlikely that Congress in its consideration of section 1(16)(b) desired to provide a monetary incentive for the unlawful abandonment of rail service. Rewarding a railroad for avoiding such a legal obligation would be contrary to public policy.

ICC REPORT, *supra* note 30, at 251, 265 (citation omitted).

In support of the ICC's position on the rent issue, the court emphasized that section 1(16)(b) provided for monetary compensation, not to the *other* carrier, but to the *directed* carrier for the costs incurred under a directed service. 540 F.2d at 80; *see* 49 U.S.C. § 1(16)(b)(E) (Supp. V 1975). For the text of this section, *see* note 4 *supra.*

41. 540 F.2d at 81.

42. *Id.*

43. *Id.* at 82. The ICC's power to order continued service pending a certification of abandonment is found in section 1(18) of the ICA, which provides in pertinent part:

> [N]o carrier by railroad subject to this chapter shall abandon all or any portion of a line of railroad, or the operation thereof, unless and until there shall first have been obtained from the Commission a certificate that the present or future public convenience and necessity permit of such abandonment.

49 U.S.C. § 1(18) (1970). In drawing the comparison, the court cited cases in which the ICC had ordered a carrier to continue to provide service. 540 F.2d at 82 nn. 34 & 36, *citing* New Haven Inclusion Cases, 399 U.S. 392, 461, 491–92 (1970) (ICC's requirement that the New York, New Haven & Hartford Railroad continue to operate at a substantial loss for six years pending reorganization was not a taking necessitating compensation), Continental Illinois Nat'l Bank & Trust Co. v. Chicago, R.I. & Pac. Ry., 294 U.S. 648, 680–81 (1935) (restricting creditors from liquidating collateral of debtor railroad comported with the purpose of section 77 of the Bankruptcy Act), *and In re* Penn Central Transp. Co., 384 F. Supp. 895, 919 (Regional Rail Reorganization Act Special Court 1974) (reorganization plan provided in the Rail Act was fair and equitable and railroads could be compelled to implement such a plan).

44. 399 U.S. 392 (1970).

required to continue to operate for six years while incurring substantial operating losses pending reorganization.[45] By way of contrast, the court noted that the maximum duration of directed service was 240 days,[46] that L & NE was spared any further operating losses because it was relieved of its obligation to continue service, and that substantial benefits flowed to L & NE as a result of the operation.[47] Furthermore, the court determined that the only hardship imposed upon L & NE was the postponement of its right to pursue abandonment.[48] The Third Circuit agreed with Supreme Court authority holding that the exercise of the rights and remedies of the railroads could be qualified by the need to protect the public interest in uninterrupted rail service[49] and that a temporary impairment of these rights and remedies, even if accompanied by losses for the owner, did not constitute a compensable taking.[50] Thus, the court concluded that L & NE was not entitled to compensation for the postponement of its right to abandon operations.[51] Although L & NE contended that these authorities were inapposite since they involved "erosion takings" while directed service constituted a "conveyance taking,"[52] the Third Circuit declined to draw this

45. *Id.* at 490–93.

46. 540 F.2d at 84. This duration is prescribed in section 1(16)(b)(A) of the ICA. 49 U.S.C. § 1(16)(b)(A) (Supp. V 1975).

47. 540 F.2d at 84. The benefits that the ICC claimed L & NE had received from the directed service over its lines included:

(1) L & NE was relieved of further operating losses during this period;
(2) its rail properties were prevented from further deterioration;
(3) its properties were upgraded to safe operating standards;
(4) directed service led directly to agreements between L & NE and LVRR and Reading to continue service over L & NE's lines; and
(5) directed service facilitated inclusion of L & NE's properties in the Final System Plan.

Id. at 78 n.20.

48. *Id.* at 84. Subsequent to instituting the instant suit, L & NE filed a certificate to abandon operations as required by section 1(18) of the ICA, 49 U.S.C. § 1(18)(1970). 540 F.2d at 77. This action was taken nine months after L & NE had determined that it could no longer operate its lines. *Id.*

49. 540 F.2d at 83 n.37, *citing* Penn Central Merger and Norfolk & Western Inclusion Cases, 389 U.S. 486, 510–11 (1968) (ICC's plan to merge railroads into the Penn Central system was valid, in light of public interest, despite ICC's refusal to protect bondholders' rights), Dayton-Goose Creek Ry. v. United States, 263 U.S. 456, 481 (1924) (ICC's regulation of rates requiring carriers to hold earnings in excess of a fair return as trustee for Government was valid because the purpose was to create an efficient railroad system), *and* The New England Divisions Case, 261 U.S. 184, 194–95 (1923) (unequal rate division designed to preserve public interest by relieving financial ills of railroads in New England area held valid).

50. 540 F.2d at 83, *citing* New Haven Inclusion Cases, 399 U.S. 392, 490–93 (1970), RFC v. Denver & R.G.W.R.R., 328 U.S. 495, 535–36 (1946) (reorganization plan for rail carrier which provided that holders of general mortgage bonds would receive stock with face amount equal to 10% of their claims was a valid exercise of the federal bankruptcy power), Continental Illinois Nat'l Bank & Trust Co. v. Chicago, R.I. & Pac. Ry., 294 U.S. 648, 680 (1935), *and In re* Penn Central Transp. Co., 384 F. Supp. 895, 919 (Regional Rail Reorganization Act Special Court 1974) (reorganization plan provided in Rail Act was fair and equitable and railroads could be compelled to implement such a plan).

51. 540 F.2d at 84.

52. *Id.* The court classified as "erosion takings" those situations in which railroads were ordered to continue deficit operations, thereby eroding their assets. *Id.*

distinction[53] and held that directed service did not effect a taking within the meaning of the fifth amendment.[54]

Finally, upon finding that the ICC's distinction between profitable and unprofitable periods of directed service — the criterion used in determining whether rent to the other carrier would be classified as reimbursable[55] — was not arbitrary or capricious, the court denied L & NE's petition to review and vacate the ICC cost regulations in question.[56]

The instant court's conclusion that the ICC possesses the *implied* statutory authority to determine which expenses of a directed service are reimbursable[57] was not without precedent.[58] Furthermore, the reasons

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The term "conveyance takings" was used by the court to describe government actions resulting in a physical seizure of a carrier's lines. *Id.*

53. *Id.* The court's refusal to distinguish these two types of governmental activity — "erosion" and "conveyance" takings — was based upon its reluctance to differentiate between ordering an incapacitated carrier to continue operations and directing another carrier to provide service over the lines of a defunct carrier. *Id.* The court found it anomalous to conclude that the differences in the relief offered by these two methods of preserving rail transportation justified holding that the latter constitutes a taking while, as had been previously determined, the former does not. *Id.; see* notes 43–47 and accompanying text *supra.*

54. 540 F.2d at 84. In holding that directed service did not effect a taking, the court emphasized that it was not addressing the question of whether a taking would occur where a carrier was forced to incur large losses without compensation for an indefinite time while no solution was forthcoming. *Id.* at 83 n.38. The court also did not reach the issue of whether the benefits received by the other carrier from a directed operation would constitute just compensation in the absence of the payment of rent for the use of its facilities. *Id.* at 82 n.32.

55. The ICC's distinction between unprofitable and profitable periods of directed service as the test for the appropriateness of reimbursing the directed carrier for rental payments made to the other carrier was based upon the conclusion that the benefits received by the other carrier from directed service might be insufficient only when such operation was profitable. ICC REPORT, *supra* note 30, at 251, 266. For a list of the specific benefits L & NE received, *see* note 47 *supra.*

56. 540 F.2d at 85.

57. *Id.* at 78–79; *see* notes 35–37 and accompanying text *supra.*

58. Courts reviewing administrative actions have not required express statutory authorization to uphold the legitimacy of the action. Rather, they have examined whether the authority could be implied through an appraisal of the purpose and the subject matter of the statute. *See* United States v. Pennsylvania R.R., 323 U.S. 612, 616 (1945) (power of the ICC to order a railroad to allow a carrier by water to use the railroad's cars when carrier by water could transport by the carload could be inferred from Transportation Act of 1940); Chicago, R.I. & Pa. R.R. v. United States, 274 U.S. 29, 36 (1927) (although power of the ICC to establish joint rail and water rates was not expressly provided in the ICA, it was derived from this statute); Federal Deposit Ins. Corp. v. Summer Financial Corp., 451 F.2d 898, 904 (5th Cir. 1971) (empowering the FDIC to sue and be sued and to regulate advertisement of interest rates carried with it the implied ability to seek injunctive relief); Mesa Petroleum Co. v. Federal Power Comm'n, 441 F.2d 182, 187 (5th Cir. 1971) (Federal Power Commission's authority to order a refund for termination of gas supply was implied under its power to certify contracts for sale of gas under the Natural Gas Act); Niagara Mohawk Power Corp. v. Federal Power Comm'n, 379 F.2d 153, 158 (D.C. Cir. 1967) (under its statutory authority to grant licenses to power companies, Federal Power Commission had the implied power to authorize the effective date of any such license prior to the date of issuance).

In holding that the ICC had the implied power under section 1(16)(b)(E) of the ICA to exclude certain costs from the amount to be reimbursed to the directed carrier, the court in the principal case relied upon the *purpose* of the Rail Act and the breadth of the *subject matter* within the ICC's administration. *See* 540 F.2d at 79–80; notes 36

underlying the need for directed service[59] and for reimbursement of costs to a directed carrier[60] support the court's holding that Congress did not intend the other carrier to receive rent for the use of its facilities.[61] However, the court's holding on the constitutional issue — that nonpayment of rent by a directed carrier to the other carrier in periods of unprofitable directed service

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& 37 *supra*. Thus, the instant court followed the same analysis employed by other courts in determining whether authority for an administrative action could be implied.

By not fully developing the supermanagement rationale to which it alluded, the court in the principal case overlooked an additional justification for its determination that the ICC had the statutory authority to determine which costs of a directed service would be reimbursable. *See* 540 F.2d at 80, *citing* Florida E. Coast Ry. v. United States, 259 F. Supp. 993, 997 (M.D. Fla. 1966), *aff'd*, 386 U.S. 544 (1967). The delegation of the auditing function and the reimbursement function to the ICC and the Treasury Department, respectively, raises the question as to why the Congress did not delegate the entire accounting and reimbursement duty to the Secretary of the Treasury. *See* 49 U.S.C. § 1(16)(b)(E) (Supp. V 1975). Had the court dealt more extensively with this question, it could have looked for guidance to Akron, C. & Y.R.R. v. United States, 370 F. Supp. 1231 (D. Md. 1975), wherein the court stated:

> [N]o great acquaintance with practical affairs is required to know that prescience, either in fact or in the minds of Congress, does not exist. Its very absence, moreover, is precisely why regulatory agencies such as the Commission are created, for it is the fond hope of their authors that *they bring to their work the expert's familiarity with industry conditions* which members of the delegating legislatures can not be expected to possess.

Id. at 1235–36 (dicta) (emphasis added). Thus, the instant court could have concluded that the delegation of the auditing function to the ICC and the more ministerial reimbursement function to the Secretary of the Treasury evidenced Congress' recognition that the ICC, as the supermanagement agent of the transportation industry, possessed the expertise lacking in Congress or the Treasury Department to limit the expenditures of a directed carrier to those absolutely necessary to the performance of a directed service. Therefore, if the ICC's power to audit included the authority to deny reimbursement for unreasonable costs, Congress could most effectively insure that federal expenditures would be kept at a minimum — one of the explicit purposes of the Rail Act. *See* 45 U.S.C. § 701(a)(6) (Supp. V 1975). Furthermore, Congress' failure to grant to the Secretary of the Treasury the power to deny reimbursement for some of the expenses of a directed service, a power which would also minimize federal expenditures, could have been construed as evidence of a congressional choice aimed at limiting federal expenditures on the basis of the *expert* decisions of the ICC, thereby insuring that sufficient assistance would be provided for the continuation of rail services threatened with cessation — another explicit purpose of the Rail Act. *See id* § 701(a)(3).

59. The amendment to section 1(16) of the ICA was drafted to prevent "any real or threatened shutdown of necessary rail service." S. REP. NO. 302, *supra* note 3, at 7. *See also* [1973] U.S. CODE CONG. & AD. NEWS 3242, 3251, 3292 (additional statements supporting the proposition that the purpose of section 1(16)(b) was to prevent a disruption of essential rail service). The primary purpose of section 1(16)(b) was to protect the public interest in uninterrupted rail service, not to fortify the financial position of an incapacitated carrier. ICC REPORT, *supra* note 30, at 251, 259. Therefore, it could be maintained that to argue that Congress intended the incapacitated carrier to receive compensation for the use of its lines would be inconsistent with the purpose of directed service.

60. Section 1(16)(b)(E) was included only to ease the financial burden which directed service could foreseeably impose upon a directed carrier. S. REP. NO. 302, *supra* note 3, at 7; *see* text accompanying note 28 *supra*. It is difficult to argue that this statutory provision for payment to the directed carrier should be viewed as evidence of a congressional intent to reimburse the other carrier for the use of its lines.

61. 540 F.2d at 81; *see* notes 39–41 and accompanying text *supra*. The ICC's view of the role which a directed carrier would be required to assume confirms the holding

did not constitute a taking for which just compensation was required[62] — is far more problematical. The court discussed two factors considered determinative of the question of whether there had been a taking: 1) the minimal harm, and even benefit to, L & NE;[63] and 2) the overriding public interest in the continuation of rail service as compared to any loss which L & NE had sustained.[64] However, by its refusal to distinguish between "erosion" and "conveyance" takings,[65] the court did not fully consider the effect of the government's physical occupation of L & NE's property on the taking issue.[66]

The federal government used and occupied L & NE's property during the period of directed service through the presence of its agents — directed carriers LVRR and Reading.[67] Although a particular carrier's ability to exercise its rights and remedies is restricted both by an ICC order requiring a continuation of service until a certificate of abandonment is acquired,[68] and by an ICC order imposing a directed service over its lines,[69] the former is not accompanied by the physical intrusion which is an integral aspect of the latter. Basing a distinction between a compensable taking and a legitimate regulation upon the physical occupation of the government may indeed produce anomalous results with regard to the ICC's authority to regulate the railroad industry.[70] However, it is submitted that the court

that the other carrier was not entitled to rent. The ICC stated: "Section 1(16)(b) envisions that a directed carrier will, to the extent that the Commission orders it to perform a particular operation, *step into the shoes of the other carrier* in relation to that operation." ICC REPORT, *supra* note 30, at 251, 261 (emphasis added). Although this statement was made in relation to the obligation of the directed carrier to assume the duties of the other carrier during a period of directed service with respect to such functions as collecting and disbursing revenues, handling all purchasing and billing, and undertaking all operating functions, *id.*, this view of the directed carrier's role can reasonably be extended to the discussion of the payment of rent to the other carrier.

Thus, if the directed carrier's costs exceeded revenues, the other carrier should not be entitled to rent for the use of its facilities because it would have incurred a loss had it operated during this period. Conversely, if the directed service was profitable, it follows that the other carrier should be entitled to receive rent because it would have sustained a profit had it operated during this period. This view of the role of the directed carrier clarifies the reasons underlying the court's holding that Congress did not intend to provide rent to the other carrier, and that, therefore, the ICC did not abuse its statutory authority by denying reimbursement for rent.

62. 540 F.2d at 82; *see* notes 42–54 and accompanying text *supra.*

63. 540 F.2d at 84; *see* note 19 *supra; see also* notes 47 & 48 and accompanying text *supra.*

64. 540 F.2d at 83; *see* note 19 *supra; see also* text accompanying notes 49–51 *supra.*

65. 540 F.2d at 84.

66. *See* 540 F.2d at 83. Physical occupation is one of the four factors generally considered crucial in classifying an activity as a taking requiring compensation. Michelman, *supra* note 17, at 1183–84. For a list of the other factors and a discussion of the taking issue, *see* note 19 and accompanying text *supra.*

67. 540 F.2d at 82. For a discussion of the presence of a directed carrier on the other carrier's property, *see* text accompanying note 23.

68. This ICC power is contained in section 1(18) of the ICA, 49 U.S.C. § 1(18) (1970). For the pertinent text of this section, *see* note 43 *supra.*

69. This ICC power is contained in section 1(16)(b) of the ICA. For a discussion of the court's comparison of these two powers of the ICC, *see* text accompanying notes 43–47 *supra.*

70. In explaining its decision not to distinguish between "erosion" and "conveyance" takings, the court noted: "It might be anomalous indeed if the ICC could order forced deficit operations by a railroad and not effect a taking, but could

should not have rejected this distinction which has been determinative for many courts in holding that a taking has been effected.[71] In relying upon the *New Haven Inclusion Cases*,[72] the instant court embraced the "public rights" theory articulated in *New Haven*,[73] and in applying this theory, the Third Circuit, in the name of public interest, extended the degree of intrusion permitted before a taking occurs. This extension may well have been unwarranted because the regulation at issue in the principal case resulted in a physical intrusion by the government, whereas the regulation challenged in *New Haven* did not.[74] In *New Haven*, and in other cases where economic regulations have been upheld in the face of a taking challenge, the government or one of its agents ordered the *private owners* to do or refrain from doing something to or with their property.[75] Conversely, directed service, involves the government directing *itself* to use and occupy private property. This difference in the nature of the regulation at issue, based upon the element of physical occupation, could have supported a conclusion that directed service constituted a taking for which compensation was required.[76]

The court's holding on the taking issue became ambiguous when it subsequently considered the reasonableness of distinguishing between

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not order another carrier to discharge those same duties, thereby in the usual case saving that railroad operating costs, without such action constituting a taking." 540 F.2d at 84; *see* notes 52 & 53 and accompanying text *supra*.

71. *See* note 20 and accompanying text *supra*.

72. *See* 540 F.2d at 83. For a discussion of this decision, *see* text accompanying notes 44 & 45 *supra*.

73. 399 U.S. 392, 491–92 (1970); *see* Note, *Takings and the Public Interest in Railroad Reorganization*, 82 YALE L.J. 1004 (1973), wherein the author explained:

> Since *New Haven* was by traditional analysis a takings situation, the case's "public rights" theory supplies a rationale — with very uncertain boundaries — for transferring private property into the public domain. Whenever a public interest is sufficiently compelling, it seems, the public may take a first claim on the use of private property.

Id. at 1016.

74. *See* 399 U.S. at 403–07. The New York, New Haven & Hartford Railroad was forced to continue to operate for six years while incurring substantial losses. *Id.* In contrast, in the instant case L & NE was ordered to permit LVRR and Reading to operate its lines. 540 F.2d at 76.

75. *See* Goldblatt v. Town of Hempstead, 369 U.S. 590 (1962); Baltimore & O. R.R. v. United States, 345 U.S. 146 (1953) (rate regulations on carloads of fresh vegetables was a legitimate exercise of the ICC's authority); Friedlander v. Cimino, 385 F. Supp. 1357 (S.D.N.Y. 1974), *rev'd on other grounds*, 520 F.2d 318 (2d Cir. 1975) (state regulation that permit for non-physician-operated clinical laboratories required proficiency tests was proper exercise of the state's police power).

76. For examples of the traditional judicial reliance upon physical occupation as being determinative of the taking issue, *see* note 20 *supra*. For a discussion of regulations and the fifth amendment taking clause, *see generally* Dunham, Griggs v. Allegheny County *in Perspective: Thirty Years of Supreme Court Expropriation Law*, 1962 SUP. CT. REV. 63; Michelman, *supra* note 17; Sax, *supra* note 18; Sax, *Takings and the Police Power*, 74 YALE L.J. 36 (1964).

It should be noted that the recognition of directed service as a taking of private property would not have destroyed the legitimacy of section 1(16)(b) of the ICA. Rather, it would have merely compelled the court to determine what would constitute just compensation for the use of the other carrier's lines during the limited period of directed service. *See* 540 F.2d at 82 n.32; *see also* note 54 *supra*. The result could easily have been the same, *i.e.*, the benefits received by the other carrier during the operation could have been held to be constitutionally sufficient compensation

profitable and unprofitable periods of directed service as the criterion for allowing reimbursement for rent paid to the other carrier. By concurring with the ICC's determination that the benefits normally conferred upon the other carrier may be insufficient when the directed service was profitable,[77] the court seemed to merge its analysis of whether there had been a taking with the subsidiary question of whether there had been just compensation. In its holding with regard to the issue of reasonableness,[78] it is submitted that the court implied that directed service is a *taking,* and that whereas the payment of rent is necessary to provide sufficient compensation during profitable operations, the benefits resulting from directed service are sufficient compensation when the operation is unprofitable. Although this interpretation of the court's holding creates a good deal of confusion concerning the court's determination of the taking question, it would appear to be the only reasonable explanation of why rent was deemed to be necessary during periods of profitable directed service.

The impact of the present decision will most likely center upon the court's holding that directed service does not constitute a taking. The departure from the traditional emphasis upon physical occupation as determinative of a taking[79] and the expansion of the vague boundaries of *New Haven*[80] may sanction further noncompensable governmental intrusions into private property. Whether the application of this decision will be restricted to the railroad industry remains to be seen. However, if it is applied to other governmental uses of private property in order to preserve a superior public interest, the just compensation clause of the fifth amendment could be seriously eroded. Furthermore, if the holding was based upon an implied determination that the ICC had provided just compensation for a taking which did occur during the directed service,[81] the court's confusing language may mislead other courts into applying the present court's decision to answer the threshold question of whether there has been a *taking,* rather than applying this decision to the subsequent question of whether there has been *just compensation.*[82] This misapplication of the present decision could lead other courts to hold that the government's

except when the directed carrier sustained a profit. In the case of a profitable directed service, the payment of rent would have to accompany the benefits in order to constitute just compensation. For a list of the benefits which would constitute compensation to L&NE for the use of its facilities, *see* note 47 *supra.*

Monetary reimbursement is not the only type of compensation that will satisfy the just compensation clause of the fifth amendment. The United States Supreme Court has stated: "The clear implication of other decisions is that consideration other than for cash — for example, any special benefits to a property owner's remaining properties — may be counted in the determination of just compensation." Regional Rail Reorganization Act Cases, 419 U.S. 102, 151 (1974), *citing* Bauman v. Ross, 167 U.S. 548, 584 (1897). Thus, the benefits received by the other carrier during a directed service could be classified as the type of just compensation contemplated by the fifth amendment.

77. 540 F.2d at 85; *see* notes 55 & 56 and accompanying text *supra.*
78. 540 F.2d at 85; *see* text accompanying note 56 *supra.*
79. *See* text accompanying note 71 *supra.*
80. *See* note 73 and accompanying text *supra.*
81. *See* text accompanying notes 77 & 78 *supra.*
82. *See* text accompanying notes 77 & 78 *supra.*

physical occupation of private property is not a taking without examining whether the citizen has received any form of compensation. This result would also tend to abridge private property owners' rights under the fifth amendment. Therefore, due to the confusion the court may have created by merging its analysis of the taking and just compensation issues,[83] its holding that directed service did not constitute a taking for which compensation was required[84] may well curtail the application of the fifth amendment.

Patricia A. Godfrey

CONSUMER PROTECTION — TRUTH IN LENDING ACT — WHEN A SELLER RECEIVES A COMMISSION FOR REFERRING A CUSTOMER TO A LENDER, HE, AND NOT THE LENDER, HAS THE DUTY TO MAKE CREDIT SALE DISCLOSURES UNDER SECTION 128.

Manning v. Princeton Consumer Discount Co. (1976)

Janet Manning agreed to purchase an automobile from Springfield Dodge, Inc. (Springfield), which assisted her in obtaining financing from the Princeton Consumer Discount Company (Princeton).[1] Princeton made the consumer loan disclosures as required by section 129 of the Truth in Lending Act (Act),[2] but neither Springfield nor Princeton made the additional credit sale disclosures required by section 128.[3] Manning brought a class action[4] against Springfield and Princeton alleging that section 128 required both the seller and the lender to make the additional disclosures.[5] The United

83. *See* text accompanying notes 77 & 78 *supra.*

84. 540 F.2d at 82; *see* note 54 and accompanying text *supra.*

1. Manning v. Princeton Consumer Discount Co., 397 F. Supp. 504 (E.D. Pa. 1975), *aff'd,* 533 F.2d 102 (3d Cir.), *cert. denied,* 97 S. Ct. 173 (1976). Springfield obtained the necessary information from the plaintiff, informed her that the preparations had been taken care of, and drove her to Princeton's office in order to complete the transaction. *Id.* Springfield received a commission from Princeton. *Id.*

2. Truth in Lending Act, § 129, 15 U.S.C. § 1639 (1970). Section 129 requires the lender to disclose certain basic credit terms such as the amount of credit, all charges, and the amount of the finance charge. *Id.*

3. *See* notes 8–12 and accompanying text *infra.*

4. Manning v. Princeton Consumer Discount Co., 390 F. Supp. 320 (1975). For purposes of injunctive relief, Mrs. Manning was certified as a representative of the class of persons who had not received disclosures from Springfield as required by section 128 of the Act. *Id.* at 324. Plaintiff's motion to have Springfield certified as a class representative was denied. *Id.* Apparently, in failing to establish the number of sellers engaging in the same conduct and to show an "industry-wide" practice, she did not meet the "numerosity" and "typicality" requirements of rule 23, FED. R. CIV. P. 23. Manning v. Princeton Consumer Discount Co., 533 F.2d 102, 104 (3d Cir.), *cert. denied,* 97 S. Ct. 173 (1976).

5. 533 F.2d at 104.

States District Court for the Eastern District of Pennsylvania held that the lender was not required to make the additional disclosures.[6] On appeal, the Third Circuit[7] affirmed the district court's decision, *holding* that Springfield, as seller, was alone responsible for making the section 128 disclosures. *Manning v. Princeton Consumer Discount Co.*, 533 F.2d 102 (3d Cir.), *cert. denied*, 97 S. Ct. 173 (1976).

In reaching this result the *Manning* court initially decided that a "credit sale" within the meaning of section 128 had in fact taken place.[8] Section 103 of the Act defines a "credit sale" as one in which credit is arranged or extended by the seller.[9] Under Regulation Z of the Federal Reserve Board,[10] a seller arranges for credit if he either accepts a fee, or participates in preparing the contract documents and has knowledge of the credit terms.[11] Since Springfield received a fee for referring the plaintiff to Princeton, the court concluded that it was also a creditor.[12]

Once having determined that both defendants were creditors, the court addressed the principal question of whether both the seller and the lender were responsible for section 128 disclosures in a credit sale transaction or whether the seller alone was responsible for those disclosures.[13] While section 121 of the Act refers generally to each creditor's responsibility to

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6. Manning v. Princeton Consumer Discount Co., 397 F. Supp. 504 (E.D. Pa. 1975).

7. The case was heard by Chief Judge Seitz and Judges Van Dusen and Weis. Judge Weis wrote the opinion.

8. 533 F.2d at 104–05.

9. Truth in Lending Act, § 103, 15 U.S.C. § 1602 (1970).

10. The Federal Reserve Board was given the power to make regulations to carry out the aims of the Act. Truth in Lending Act, § 105, 15 U.S.C. § 1604 (1970); *see* Mourning v. Family Publications Serv., Inc., 411 U.S. 356, 363–75 (1973). These regulations, 12 C.F.R. §§ 226.1–.1002 (1976), known as Regulation Z, and the Board interpretations thereof that are issued from time to time, have been given great weight by the courts. *See* Frank v. Reserve Consumer Discount Co., 398 F. Supp. 703, 704–05 (W.D. Pa. 1975); Bloomer v. McKnight Rd. Dodge, Inc., 397 F. Supp. 403, 404 (W.D. Pa. 1975). Although interpretations issued by the Federal Reserve Board are treated as "persuasive authority," they are not considered binding upon the courts. *See* Ljepava v. M.L.S.C. Properties, Inc., 511 F.2d 935, 941 (9th Cir. 1975); Eby v. Reb Realty, Inc., 495 F.2d 646, 649–50 (9th Cir. 1974).

11. Regulation Z, 12 C.F.R. § 226.2(h)(1), (2) (1976). The regulation states specifically that a seller arranges for credit if he: "(1) Receives or will receive a fee, compensation, or other consideration for such service, or (2) [h]as knowledge of the credit terms and participates in the preparation of the contract documents required in connection with the extension of credit." *Id.* For cases discussing the issue of when a seller is also a creditor under the Truth in Lending Act, *see* Stefanski v. Mainway Budget Plan, Inc., 465 F.2d 211 (5th Cir. 1972), *rev'g* 326 F. Supp. 138 (S.D. Fla. 1971); Childress v. Mobile Living Corp., 386 F. Supp. 903 (E.D. La. 1974); Meyers v. Clearview Dodge Sales, Inc., 384 F. Supp. 722 (E.D. La. 1974); Starks v. Orleans Motors, Inc., 372 F. Supp. 928 (E.D. La. 1974), *aff'd*, 500 F.2d 1182 (5th Cir. 1975). *See generally* Moo, *Closed End Credit Disclosure*, 26 BUS. LAW. 809 (1971).

12. 533 F.2d at 105. The court read section 226.2(h)(1), (2) in the disjunctive, interpreting the wording "and participates in the preparation of the contract documents" as applying to only the wording "has knowledge of the credit terms," and not applicable to "receives or will receive a fee." *Id.*

13. The pertinent language of section 128 merely states that "the creditor shall disclose each of the following. . . ." Truth in Lending Act, § 128, 15 U.S.C. § 1638(a) (1970).

make disclosures to each borrower,[14] the Act is unclear as to disclosure responsibilities in a multiple creditor transaction. The Federal Reserve Board promulgated section 226.6(d) of Regulation Z in an effort to clarify the matter, which states in pertinent part that "disclosures required under paragraphs (b) and (c) of § 226.8 shall be made by the seller if he arranges . . . credit. Otherwise, disclosures shall be made as required under paragraphs (b) and (d) of § 226.8."[15] By interpreting this last sentence of section 226.6(d) as applying only to a situation where the seller does not extend or arrange credit,[16] the court was able to conclude that where the seller does extend or arrange credit it alone has the duty of making disclosures.[17]

In order to bolster its interpretation, the court argued that in practice it would be foolish and of little value for the consumer to receive two sheets of paper containing exactly the same information.[18] Furthermore, since the three items listed in section 128, and not found in section 129, are the cash price, the amount of downpayment, and the unpaid balance of the cash price,[19] the court believed that they were more likely to be known by the seller than by the lender.[20]

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14. Truth in Lending Act, § 121, 15 U.S.C. § 1631 (Supp. V 1975). Section 121 states: "Each creditor shall disclose clearly and conspicuously, in accordance with the regulations of the Board, to each person to whom consumer credit is extended, the information required under this part or part D of this subchapter." *Id.*

15. 12 C.F.R. § 226.6(d) (1976). The regulation states:

> If there is more than one creditor in a transaction, . . . [each] shall be responsible for making only those disclosures required by this part which are within his knowledge and the purview of his relationship with the customer.
>
> . . . .
>
> The disclosures required under paragraphs (b) and (c) of § 226.8 shall be made by the seller if he extends or arranges for the extension of credit. Otherwise disclosures shall be made as required under paragraphs (b) and (d) of § 226.8.

Id. Paragraphs (b) and (c) list items for disclosure required by section 128 of the Truth in Lending Act. *Id.* § 226.8(b), (c). Paragraphs (b) and (d) list items required by section 129. *Id.* §§ 226.8(b), (d).

16. The court stressed that the word "otherwise" sets off the lender's disclosure responsibilities from those of the seller, and that it is only where the seller does not also qualify as a creditor that the lender is required to make disclosures referred to in the last sentence of section 226.6(d). 533 F.2d at 105. The court further stated that "the specific direction of the third sentence prevails over the general language limiting the scope of disclosure to items within the creditor's knowledge and the purview of his relationship with the customer." *Id.*

17. *Id.*

18. *Id.* at 106. Plaintiff proposed a "fail-safe" theory, which would require both the seller and lender to make section 128 disclosures in order to be doubly sure that the buyer receives the required information. *Id.* The court rejected this argument, stating that the sanctions imposed by the Act under section 130, 15 U.S.C. § 1640(a) (Supp. V 1975), were sufficient to insure the seller's compliance with the disclosure requirements of section 128. 533 F.2d at 106. For a discussion of section 130, *see* note 32 *infra*.

19. Truth in Lending Act, § 128, 15 U.S.C. § 1638 (1970).

20. 533 F.2d at 105.

In reaching its decision, the Third Circuit rejected the "conduit" theory set forth by the plaintiff.[21] The theory holds that where a lender and a seller are closely tied, the lender may not escape responsibility for making disclosures by using the seller as a "front man."[22] The court distinguished *Manning* from the conduit cases[23] on the ground that none of those cases had considered section 226.6(d)'s requirement that the seller be responsible for making the required disclosures "if he extends or arranges for the extension of credit."[24]

Although the Third Circuit in *Manning* engaged in a careful analysis of the applicable statutory and regulatory provisions, it is not at all certain that the opinion clarifies the individual disclosure responsibilities in a multiple creditor situation. On the one hand, the opinion may be read as stating that the lender will not be responsible for the additional disclosures in section 128,[25] but that he is nevertheless responsible for making section 129 disclosures.[26] On the other hand, *Manning* may be read as standing for the proposition that where a seller arranges for the extension of credit, he

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21. *Id.* at 106 n.4. The conduit theory is part of the judicial effort to limit the immunity of a "holder in due course." For a discussion of the "holder in due course" doctrine as it relates to Truth in Lending requirements, *see* Currie, *The Holder in Due Course in the Aftermath of the Truth in Lending Act*, 52 CHI. - KENT L. REV. 95 (1975).

22. Garza v. Chicago Health Clubs, Inc., 347 F. Supp. 955 (N.D. Ill. 1972). In *Garza*, a finance company was the regular assignee of a health club's membership installment contracts. The court held that an assignee of a consumer credit sales contract who regularly extends or arranges for the extension of credit through an assignor of the contracts may himself be a creditor. 347 F. Supp. at 964. As creditors they would be responsible for disclosures. *Accord*, Kriger v. European Health Spa, Inc., 363 F. Supp. 334 (E.D. Wis. 1973) (bank which discounted notes held liable for disclosures); Philbeck v. Timmers Chevrolet, Inc., 361 F. Supp. 1255 (N.D. Ga. 1973), *rev'd on other grounds*, 499 F.2d 471 (5th Cir. 1974) (automobile manufacturer who prepared contracts for dealer who assigned completed contracts back to manufacturer held responsible for disclosures). *See also* Joseph v. Norman's Health Clubs, Inc., 336 F. Supp. 307 (E.D. Mo. 1971).

23. 533 F.2d at 106 n.4.

24. 12 C.F.R. § 226.6(d) (1976); *see* note 15 *supra*. The *Manning* court obviously found section 226.6(d) controlling. 535 F.2d at 105–06. The district court in *Manning* recognized that section 226.6(d) was difficult to understand and that at least one district court had changed its interpretation of the regulation. 397 F. Supp. at 507, *comparing* Boggan v. Euclid Nat'l Bank, No. C73–275, (N.D. Ohio Oct. 31, 1974), *vacated and remanded* 513 F.2d 630 (6th Cir. 1975), *with* Pitts v. Society Nat'l Bank, Civil No. C74–556, (N.D. Ohio March 7, 1975).

The cases relied upon by the plaintiff could have been also distinguished by the *Manning* court on the ground that they dealt with situations where a consumer contract was assigned to a lender by a seller, behind whom the lender was surreptitiously protected. *See* Philbeck v. Timmers Chevrolet, Inc., 361 F. Supp. 1255 (N.D. Ga. 1973), *rev'd on other grounds*, 499 F.2d 471 (5th Cir. 1974); Garza v. Chicago Health Clubs, Inc., 347 F. Supp. 955 (N.D. Ill. 1972).

25. Federal Reserve Board opinions have supported the view that the seller alone is responsible for the added section 128 disclosures. *See* 5 CONS. CRED. GUIDE (CCH) ¶¶ 30,399, 30,996 (1974); *cf. id.* ¶ 31,100.

26. Princeton did in fact make section 129 disclosures. 533 F.2d at 104. The Third Circuit's interpretation of the district court holding was that the lender "was not required to make any *further* disclosures." *Id.* (emphasis added). This implies that the lender is still responsible for section 129 disclosures but not section 128 disclosures. However, later in the opinion the court states that "[b]ecause the burden of full disclosure was placed upon the seller, it is our view that if additional and duplicative disclosure had been intended, the regulation would have set that forth with equal

alone is responsible for all disclosures, and the lender is exempted from any disclosure responsibility.[27]

The purpose of the Truth in Lending Act is to ensure that creditors provide consumers with sufficient information so that they may make an intelligent choice of credit options.[28] However, as the *Manning* court noted, it would be superfluous to require of a lender in a credit sale transaction the exact same disclosures that the seller is already required to make.[29] While the opinion does not clearly delineate the individual disclosure responsibilities in a multiple creditor credit sale transaction, it is submitted that in a situation where the seller has "arranged" credit, *Manning* should be interpreted as relieving the lender from his usual duty of making section 129 disclosures.[30] In such a situation, the Third Circuit has apparently placed upon the seller the sole responsibility for the disclosures required by the Truth in Lending Act.

This conclusion is warranted by a logical construction of section 226.6(d) of Regulation Z, since it would be redundant to include the "otherwise" sentence if the immediately preceding sentence already imposes disclosure responsibility upon the seller.[31] Rather, the "otherwise" sentence reserves disclosure responsibility to the lender in all situations where the seller is not also a creditor, but where the seller is also a creditor the complete disclosure responsibility shifts to it. The salutary effect of such a reading is that it

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explicitness." *Id.* at 106. If the court is expressing an opinion here that a lender, under the facts of this case, would not be responsible for *any* disclosures, then its opinion is inconsistent with the earlier interpretation of the district court opinion. Furthermore, such a view would be no more than dictum because in this case the lender had in fact made some disclosures. *See* note 2 and accompanying text *supra.*

27. *See* note 26 *supra.* The attorney for the plaintiff interpreted the Third Circuit's ruling as exempting the lender from all disclosures in a credit sale transaction: "Scanning over this general policy statement in section 226.6(d), the court reads the third sentence's requirement that the seller must provide the sale disclosures as eliminating any disclosure responsibilities by the lender in this circumstance." Petitioner's Brief for Certiorari at 9, Manning v. Princeton Consumer Discount Co., 97 S. Ct. 173 (1976).

28. Truth in Lending Act, § 102, 15 U.S.C. § 1601 (Supp. V 1975). Section 102 states:

> The informed use of credit results from an awareness of the costs thereof by consumers. It is the purpose of this title to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit.

15 U.S.C. § 1601 (Supp. V 1975). For a brief discussion of the purposes of the Truth in Lending Act, *see* Comment, *Truth in Lending and the Statute of Limitations,* 21 VILL. L. REV. 904, 909–12 (1976).

29. 533 F.2d at 106; *see* note 18 and accompanying text *supra.*

30. This means that the lender is relieved of the duty of disclosing that information which is "within his knowledge and the purview of his relationship with the customer." *See* 12 C.F.R. § 226.6(d) (1976); note 11 *supra.*

31. *See* notes 15 & 16 and accompanying text *supra.*

precludes any requirement of providing the consumer with duplicate disclosure statements, which conceivably could differ in form and consequently be confusing to a credit customer.[32]

Charles J. Heinzer IV

FEDERAL SECURITIES REGULATION — RULE 10b-5 — PLAINTIFF MUST EXERCISE DUE DILIGENCE IN CONNECTION WITH A PURCHASE OF SECURITIES AND THE BURDEN OF PROOF OF PLAINTIFF'S LACK OF DUE DILIGENCE IS ON DEFENDANT.

Straub v. Vaisman & Co. (1975)

Plaintiffs, a German securities account manager (Straub) and his clients, made several purchases of securities through defendant Vaisman & Company (VaisCo), a registered New Jersey securities broker-dealer controlled by defendant Vaisman, its president and sole stockholder.[1] In December 1972, with the knowledge that Straub was interested in new issues, VaisCo's employee recommended the purchase of 10,000 shares of Mark I Offset, which it described as a new issue that would "break" in January 1973.[2] As a financial consultant to Mark I Offset, Vaisman knew that it was not a new issue and that its bankruptcy was imminent.[3] In reliance upon the defendants' advice, Straub authorized the purchase of the stock for himself and for his clients.[4] VaisCo then purchased the stock for

32. Such an interpretation may also prevent recoveries against both the seller and the lender in a multiple creditor transaction. Section 130 of the Act provides for a penalty and recovery of twice the finance charge, with a minimum recovery of $100 and a maximum recovery of $1,000. Truth in Lending Act, § 130(a)(2)(A), 15 U.S.C. § 1640(a)(2)(A) (Supp. V 1975). A successful plaintiff may also recover actual damages. *Id.* § 1640(a). It is possible that in a multiple creditor suit, where all the creditors are found liable for Truth in Lending Act violations, each would be liable severally for the statutory penalty. This would be even more significant in class actions where recovery can amount to the "lesser of $100,000 or 1 per centum of the net worth of the creditor." *Id.* § 1640(a)(2)(B).

1. Straub v. Vaisman & Co., 540 F.2d 591, 594 (3d Cir. 1976). Straub was the managing director of Success Portfolio Management Co., located in Stuttgart, Germany. *Id.* The other plaintiffs were investment banking houses with accounts managed by Straub. *Id.* Plaintiffs authorized the securities purchases in reliance upon the advice of Erb, an employee of VaisCo held out by that company as director of international operations. *Id.*

2. *Id.* Erb had originally recommended the purchase of 10,000 shares of a different corporation, Loren Industries, but later changed his recommendation to Mark I Offset. *Id.* VaisCo was a market maker in Mark I Offset stock. *Id.*

3. *Id.*

4. *Id.*

the plaintiffs at a price higher than the current market price from a company in which defendant Vaisman held a controlling interest.[5]

After Mark I Offset filed for bankruptcy within one month of the sale, plaintiffs commenced an action in federal court for damages and rescission,[6] alleging violations of a number of federal securities provisions and SEC rules, including rule 10b–5.[7] The United States District Court for the District of New Jersey found a specific intent to defraud on the part of defendants[8] and awarded to the plaintiffs the relief requested under rule 10b–5 as well as attorneys' fees.[9] On appeal before the United States Court of Appeals for the Third Circuit, defendants claimed that the plaintiffs had not proved that they exercised due diligence in ascertaining all relevant facts prior to the transaction, and that the award of counsel fees was improper.[10] The Third Circuit[11] affirmed in part and reversed in part, *holding* 1) that in order to make out a cause of action under rule 10b–5, a purchaser of securities must exercise due diligence in determining facts surrounding the transaction, but need not bear the burden of proof as to the exercise of his due diligence; and 2) that absent evidence of fraud during the course of the litigation, an award of counsel fees is prohibited by section 28(a) of the Securities Exchange Act of 1934.[12] *Straub v. Vaisman & Co.*, 540 F.2d 591 (3d Cir. 1976).

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5. *Id.* The company, Atlas Interfund, employed Vaisman as an officer and securities advisor and held the Mark I Offset stock on his behalf. *Id.* at 594 n.2. The district court found that Vaisman planned to sell this stock through Atlas Interfund to improve VaisCo's capital position. *Id.*

6. *Id.* at 594. Straub had retained his 7,000 shares. *Id.* The other plaintiffs had sold their holdings subsequent to the filing of Chapter XI proceedings by Mark I Offset. *Id.* The stock was acquired at a price of $4 per share, and sold for 37½¢ per share. *Id.*

7. *Id.* Plaintiffs alleged violations of section 17(a) of the Securities Act of 1933 (1933 Act), 15 U.S.C. § 77q(a) (1970); sections 10(b), 15(c)(1), and 15(c)(2) of the Securities Exchange Act of 1934 (1934 Act), 15 U.S.C. §§ 78j(b), 780(c)(1)–(2) (1970); and SEC rules 10b–3, 10b–5, 15c1–1, 15c1–2, 15c1–4, 17 C.F.R. §§ 240.10b–3, .10b–5, .15c1–1, –2, –4 (1976). The district court stated that since it had found that the defendants had violated rule 10b–5, it was unnecessary to consider the plaintiffs' alternate claims. Straub v. Vaisman & Co., Civ. No. 513–73, slip op. at 15 (D.N.J. Nov. 15, 1974).

Rule 10b–5 provides:

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

17 C.F.R. § 240.10b–5 (1976).

8. 540 F.2d at 596.

9. *Id.* at 594–95.

10. *Id.* at 595–98.

11. The appeal was heard by Circuit Judges Van Dusen, Kalodner, and Weis. Judge Weis delivered the opinion for the court; Judge Van Dusen dissented as to the issue of the award of attorney's fees but concurred in the remainder of the decision.

12. Section 28(a) provides that "no person permitted to maintain a suit for damages under the provisions of this chapter shall recover . . . a total amount in

Section 10(b) of the Securities Exchange Act of 1934[13] grants the SEC broad powers "to forbid . . . any devices in connection with security transactions which it finds detrimental to the public interest or to the proper protection of investors."[14] Pursuant to this authority, the SEC promulgated rule 10b–5,[15] which makes it unlawful to employ deceptive and manipulative practices in connection with the purchase or sale of securities.[16] Despite the expansive provisions of rule 10b–5, no express remedy was provided to securities holders injured as a result of its violation.[17] However, in *Superintendent of Insurance v. Bankers Life & Casualty Co.*,[18] the Supreme Court approved the implication of such a private remedy.[19]

With the development of rule 10b–5 as a basis of substantive private liability, the courts looked to the common law in order to discern what elements were necessary to state a claim for relief under the rule and what defenses were available to defendants who had been sued for breaching its

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excess of his actual damages on account of the act complained of." 15 U.S.C. § 78bb(a) (1970). The Third Circuit found that because the award of counsel fees did not fall within an exception to the rule which ordinarily prohibits such awards, it constituted punitive damages forbidden by section 28(a). *See* Gould v. American-Hawaiian SS. Co., 535 F.2d 761 (3d Cir. 1976); Flaks v. Koegel, 504 F.2d 702 (2d Cir. 1974); Green v. Wolf Corp., 406 F.2d 291 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969).

13. Section 10(b) provides:

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

15 U.S.C. § 78j(b) (1970).

14. 78 CONG. REC. 2271 (1934) (remarks of Sen. Fletcher). *See also* 1 A. BROMBERG, SECURITIES LAW § 3.2(300)–3.2(400) (1975).

15. 17 C.F.R. § 240.10b–5 (1976). For the text of rule 10b–5, *see* note 7 *supra*.

16. *See* note 7 *supra*.

17. In addition, it did not appear that any express remedies were contemplated by Congress during the passage of section 10(b). *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 729 (1975). *See also* S. REP. No. 792, 73d Cong., 2d Sess. 5–6 (1934); 2 A. BROMBERG *supra* note 14, § 2.2; Wheeler, *Plaintiff's Duty of Due Care under Rule 10b-5: An Implied Defense to an Implied Remedy*, 70 NW. U.L. REV. 561, 564–66 (1975); 61 HARV. L. REV. 858 (1948). Moreover, the Securities and Exchange Commission (SEC) did not consider private civil remedies when it adopted rule 10b–5. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 730; *see* Birnbaum v. Newport Steel Corp., 193 F.2d 461, 463 (2d Cir. 1952); SEC Securities Exchange Act Release No. 3230 (1942); 3 L. LOSS, SECURITIES REGULATION 1469 n.87 (2d ed. 1961); *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967). However, the 1934 Act expressly provides civil remedies in certain other sections. *See, e.g.*, 15 U.S.C. §§ 78i, 78p, 78r, 78t (1970).

18. 404 U.S. 6 (1971).

19. *Id.* at 9. After the formulation of the implied 10b–5 private right of action in Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), it became the "overwhelming consensus" of federal courts that such a cause of action did exist. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1976).

obligations.[20] One result of this common law analysis was the development of the requirement of reliance as a substantive element of a 10b-5 cause of action.[21] Hence, if it is shown that the plaintiff had knowledge of the facts which he claimed the defendant did not disclose to him, the plaintiff will be barred from recovery under rule 10b-5 for lack of reliance.[22] An effect of the reliance requirement is to bar recovery by a plaintiff who did not exercise due diligence in ascertaining and interpreting material facts in connection with a sale or purchase of securities in which he was involved.[23]

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20. Royal Air Properties v. Smith, 321 F.2d 210, 213 (9th Cir. 1962). The implied defenses were necessitated by a desire to reduce to a manageable level the rapidly increasing number of private 10b-5 actions. *See* 1 A. BROMBERG, *supra* note 14, § 2.5(6); Comment, *Reliance Under Rule 10b-5: Is the "Reasonable Investor" Reasonable?*, 72 COLUM. L. REV. 562, 562-63 (1972).

For examples of such defenses and limitations, *see* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (negligence not sufficient to satisfy requirement of scienter on part of defendant); TSC Indus., Inc. v. Northway, Inc., 423 U.S. 820 (1976), *noted in* 22 Vill. L. Rev. 205 (1976) (restrictive definition of materiality); Fridrich v. Bradford, 542 F.2d 307 (6th Cir.), *cert. denied*, 97 S. Ct. 767 (1977) (privity required between purchaser and seller); James v. DuBreuil, 500 F.2d 155 (5th Cir. 1974) (no cause of action where plaintiff has knowingly participated in defendant's violation). *But see* Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50 (S.D.N.Y 1971) (defense of plaintiff's knowing participation in the culpable conduct overcome by the policy of enforcement of the antifraud provisions); City Nat'l Bank v. Vanderboom, 422 F.2d 221 (8th Cir. 1976) (test for justifiable reliance is subjective); Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952) (requirement that plaintiff be an actual purchaser or seller of securities), *approved in* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

For a discussion of the origins of these defenses, see Bucklo, *Scienter and Rule 10b-5*, 67 NW. U.L. REV. 562 (1972); Comment, *Reliance Under Rule 10b-5: Is the "Reasonable Investor" Reasonable?*, 72 COLUM. L. REV. 562 (1972); Note, *The Reliance Requirement in Private Actions Under Rule 10b-5*, 88 HARV. L. REV. 584 (1975); Comment, Blue Chip Stamps v. Manor Drug Stores: *Failure to Solve the Purchaser-Seller Problem*, 70 NW. U.L. REV. 965 (1976); Comment, *Scienter and the Flexible Duty Rule Under Rule 10b-5*, 1975 B.Y.U.L. REV. 125; Comment, *The Development of a Flexible Duty Standard of Liability Under SEC Rule 10b-5*, 32 WASH. & LEE L. REV. 99 (1975).

21. The courts have inferred the requirement of reliance for recovery for violations of section 10(b) from their perceptions of the general policy of securities legislation. *See* Comment, *Reliance Under Rule 10b-5: Is the "Reasonable Investor" Reasonable?*, 72 Colum. L. Rev. 562, 563 (1972). As one court observed: "Since civil liability was judicially implied, the appropriate common law defenses should be applicable." Royal Air Properties v. Smith, 312 F.2d 210, 213 (9th Cir. 1962); *cf.* List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir.) *cert. denied*, 382 U.S. 811 (1965) (plaintiff must establish causation).

22. The *Straub* court stated that a plaintiff with actual knowledge of material facts undisclosed by defendant could not recover, since there would be a "lack of materiality." 540 F.2d at 596. Such a plaintiff could not be said to have relied upon the absence of the undisclosed facts, since he knew of their existence. The Supreme Court has held, however, that in a case involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. Affiliated Ute Citizens v. United States, 406 U.S. 128, 154 (1972).

23. Note, *The Due Diligence Requirement for Plaintiffs Under Rule 10b-5*, 1975 DUKE L.J. 753, 754. A number of cases have discussed the issue of the plaintiff's use of due care in ascertaining all material facts concerning a particular securities transaction.

In Clement A. Evans & Co. v. McAlpine, 434 F.2d 100 (5th Cir. 1970), the court held that the plaintiff must exercise due care in order to recover. *Id.* The plaintiff, a brokerage firm, alleged an intentional violation of 10b-5 by the defendants — another

However, this was not the only aspect of the due diligence defense which was available to a defendant under rule 10b–5. Contemporaneous with the development of a reliance requirement under the rule, many courts fostered the concept that private liability for a violation of the rule could be

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brokerage firm, its agent, and one of its customers. *Id.* at 102. The Fifth Circuit, in affirming the lower court's judgment on a jury verdict for the defendants, stated that the "plaintiff's duty [of due care] is not altered merely because the misrepresentations are alleged to be intentional rather than negligent." *Id.* at 105.

However, in Carroll v. First Nat'l Bank, 413 F.2d 353 (7th Cir. 1969), the Seventh Circuit, denying the defendants' motion to dismiss the complaint, rejected their contention that the plaintiffs' negligence should bar recovery even though the complaint was based upon intentional misrepresentation. *Id.* at 357–58. The court stated: "Nothing in the legislative history of the statute has been called to our attention to show that Congress intended any such limitation. . . . Whatever the relevance of plaintiffs' negligence might be to the issues at a trial on the merits, it does not support the dismissal of the amended complaint which is based on fraud rather than negligence." *Id.* at 358.

The requirement that the plaintiff exercise due care may also be illustrated by Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963), in which the plaintiff, who had been a large stockholder, director, and officer of the defendant corporation, sued under rule 10b–5, claiming he had relied upon defendant's misrepresentations in selling his stock in the corporation to the corporation at a price lower than the fair value thereof. *Id.* at 636. The Seventh Circuit affirmed the district court's judgment for the defendant, holding that the plaintiff could not recover because, as a corporate insider and investor knowledgeable in securities dealings, he should have realized that the figures given him contained substantial discrepancies as to which "mere inquiry" on his part would have disclosed the facts. *Id.* at 641–42.

However, in Lehigh Valley Tr. Co. v. Central Nat'l Bank, 409 F.2d 989 (5th Cir. 1969), wherein the plaintiff bank sued the defendant bank for an alleged violation of rule 10b–5, the court rejected the defendant's contention that the 1934 Act "was intended only to provide protection for innocent, uninformed investors," stating that

> [n]either Congress nor the Securities and Exchange Commission had indicated that the unsophisticated and the unwary are the only wards of Rule 10b–5. . . . Therefore, in view of the fact that gullibility is not the province of any one group, the protections and remedies of the Securities Act are not accorded only to those who fail a battery of information and intelligence tests, but are simply conditioned upon the misrepresentation of material facts.

Id. at 992.

A number of courts have extended the scope of the reliance requirement by denying recovery where the plaintiff was deemed to possess "constructive knowledge" of information which he could have learned by the exercise of due diligence. *See e.g.*, Mitchell v. Texas Gulf Sulphur, 446 F.2d 90, 103 (10th Cir.), *cert. denied,* 404 U.S. 1004 (1971); Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 103–04 (5th Cir. 1970); Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1208–09 (9th Cir. 1970); Myzel v. Fields, 386 F.2d 718, 736 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968); Kohler v. Kohler Co., 319 F.2d 634, 641 (7th Cir. 1963); Phillips v. Reynolds & Co., 295 F. Supp. 1249, 1254 (E.D. Pa. 1969).

Some courts have gone so far as to give the plaintiff the burden of proof as to his own due diligence. In Financial Indus. Fund v. McDonnell Douglas Corp., 474 F.2d 514, 521 (10th Cir. 1973), plaintiff, a mutual fund, sued a corporation and its underwriter, claiming a violation of rule 10b–5 in the corporation's delay in the issuance of a special earnings statement showing unexpectedly low earnings. *Id.* at 515–16. Plaintiff relied upon defendant's inaction and made substantial purchases of the corporation's stock. *Id.* at 515. The Tenth Circuit reversed the district court's judgment on a jury verdict for plaintiff, holding that plaintiff had not met its "burden of proof to establish that it exercised due care in making its stock purchase." *Id.* at 521. However, the *Financial Fund* case was impliedly overruled in Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976). For a discussion of *Holdsworth, see* note 33 *infra.*

predicated upon negligence.[24] The courts tempered the application of this concept by drawing upon the common law concept of contributory negligence[25] and extended due diligence defense to bar recovery by a plaintiff who did not exercise due diligence in ascertaining and interpreting material facts in connection with the purchase or sale of the securities at issue in the litigation.[26] In *Ernst & Ernst v. Hochfelder*,[27] however, the Supreme Court ruled that negligent conduct could not be a proper basis for the assertion of a cause of action under rule 10b–5; rather, the Court held that absent an allegation of intent to deceive on the part of the defendant, a private 10b–5 action for damages could not be maintained.[28]

In view of the fact that the second aspect of the due diligence defense had been developed by analogy to principles of the common law within which negligence could form the basis of 10b–5 liability,[29] and because contributory negligence is not a defense at common law to an intentional tort,[30] a question was raised as to whether the holding in *Hochfelder*

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24. *See, e.g.*, White v. Abrams, 495 F.2d 724 (9th Cir. 1974). *See also* Comment, *The Development of a Flexible Duty Standard of Liability Under SEC Rule 10b–5*, 32 WASH. & LEE. L. REV. 99 (1975); Comment, *Scienter and the Flexible Duty Rule Under Rule 10b–5*, 1975 B.Y.U.L. REV. 125. *See generally* Comment, *Negligent Misrepresentations Under Rule 10b–5*, 32 U. CHI. L. REV. 824 (1965).

25. 540 F.2d at 597.

26. *Id.*

27. 425 U.S. 185 (1976).

28. *Id.* at 194–214. In *Hochfelder*, investors sustained financial losses as a result of a securities fraud perpetrated by the president of a brokerage house. *Id.* at 189. The scheme, after having continued for 24 years, was finally exposed by the president's own suicide note. *Id.* The investors filed suit against the accounting firm which had audited the brokerage house's books. *Id.* at 190. Seeking recovery under section 10(b) and rule 10b–5, the plaintiffs based their claim solely upon the defendant's alleged negligence in conducting audits of the brokerage firm. The United States District Court for the Northern District of Illinois entered summary judgment for the defendant, holding that although such an action could be maintained for negligence, there was no issue of material fact as to whether defendant had conducted its audit according to generally accepted accounting standards. *Id.* at 191. The Seventh Circuit reversed and remanded, holding that there were issues of fact as to whether defendant had been negligent in failing to investigate certain unusual circumstances, and whether such investigation would have led to discovery or prevention of the fraud. *Id.* at 191–93. The Supreme Court reversed, holding that absent an allegation of intent to deceive, manipulate, or defraud on the part of the defendant, a private action for damages could not be maintained. *Id.* at 193.

29. *See* note 24 *supra*.

30. *See* W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 108, at 716 (4th ed. 1971). The *Straub* court stated: "Under the common law, once the right to recover for intentional misrepresentation has been established, lack of care on the part of the recipient in accepting the representation as true becomes irrelevant so long as the misrepresentation is not patently false." 540 F.2d at 597, *citing* W. PROSSER, *supra; see* Rochez Bros. v. Rhoades, 491 F.2d 402, 409 (3d Cir. 1974). Rochez Brothers, a corporation, and Rhoades, an individual, each owned 50% of another corporation. *Id.* at 405. Rochez Brothers sold its stock to Rhoades for $598,000. Rhoades later sold his interest to another corporation for $4.25 million cash and 50,000 shares of the purchaser's stock. *Id.* at 406. Rochez Brothers sued under section 10(b) and rule 10b–5, claiming nondisclosure of material information concerning Rhoades' negotiations with potential purchasers prior to Rhoades' purchase of Rochez Brothers' interest. *Id.* at 405. The district court found for plaintiffs. 353 F. Supp. 795 (W.D. Pa. 1973). The United States Court of Appeals for the Third Circuit affirmed as to Rhoades' liability under rule 10b–5, but vacated and remanded on other grounds. 491 F.2d at 411, 413.

implicitly left only the reliance aspect of the due diligence defense available to 10b–5 litigants.[31] Aside from the instant case, only one circuit has considered this question. In *Holdsworth v. Strong*,[32] the Tenth Circuit reviewed the Supreme Court's decision in *Hochfelder* and held that, because a 10b–5 violation is now analogous to an *intentional* tort, "the exaction of a due diligence standard from the plaintiff becomes irrational and unrelated."[33] Hence, the court eliminated the availability of the due diligence defense insofar as it rested upon contributory negligence[34] and required only that a plaintiff demonstrate justifiable reliance upon the defendant's nondisclosures.[35]

It was against this background that the Third Circuit, after disposing of defendants' initial objections,[36] considered the viability of the due diligence defense. The court initially focused upon the pre-*Hochfelder* law relating to the defense and found that the defense was analogous to that of contributory negligence and hence a "natural development" of the inclusion

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The *Rochez* court stated that "before an insider may claim reliance on a material misrepresentation, he must fulfill a duty of due care in seeking to ascertain for himself the facts relevant to a transaction." *Id.* at 409.

31. 540 F.2d at 597–98.

32. 545 F.2d 687 (10th Cir. 1976).

33. *Id.* at 692. In *Holdsworth*, plaintiff and defendant were co-owners of a small corporation. *Id.* at 689. Plaintiff sold his interest to defendant but subsequently sued for rescission, claiming both that defendant had misrepresented the corporation's financial situation and that plaintiff's status as a corporate insider negated the need for him to use due diligence in the transaction. *Id.* The district court rendered judgment for plaintiff, and the court of appeals affirmed. *Id.* at 698. On appeal, the defendant argued that the judgment should be reversed because: 1) plaintiffs did not exercise due diligence in selling their stock; 2) plaintiffs' reliance on defendant's statement was not justified; and 3) the misrepresentations were not material. *Id.* at 691. The Tenth Circuit, reviewing both the Supreme Court's decision in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (*see* note 28 *supra*), and the common law of misrepresentation (*see* note 30 *supra*), stated that "[u]se of the tort analogy plainly demonstrates the inappropriateness of due diligence in 10b–5 suits under the *Ernst & Ernst* doctrine, for the due diligence standard as applied to 10b–5 suits is about the same as the application of contributory negligence." 545 F.2d at 694. The court declared that "where liability of the defendant requires proof of intentional misconduct, the exaction of a due diligence standard from the plaintiff becomes irrational and unrelated." *Id.* at 692. Thus, the court ruled that, to recover under rule 10b–5, a plaintiff need prove only that he justifiably relied upon a material misstatement made by the defendant. *Id.* at 695–98. Indicating that plaintiff's state of mind is still relevant, albeit to a limited extent, the court stated that reliance upon a palpably false statement is neither reasonable nor justifiable, *id.* at 694, and concluded by holding that "[i]f contributory fault of plaintiff is to cancel out wanton or intentional fraud, it ought to be gross conduct somewhat comparable to that of defendant." *Id.* at 693. In light of the court's discussion of reliance, it would seem that retaining this vestige of the due diligence requirement was unnecessary.

34. 545 F.2d at 695.

35. *Id.*

36. Although the defendants claimed that the district court had no jurisdiction to hear a 1934 Act suit by foreign nationals residing outside of the United States, the court of appeals had little difficulty in finding that plaintiffs were permitted to invoke the jurisdictional sections of the federal securities laws. 540 F.2d at 595. The question of federal jurisdiction in cases of transactional securities fraud has recently received extensive consideration. In Bersch v. Drexel Firestone, Inc., 519 F.2d 974 (2d Cir.

of negligent conduct within the prohibitions of 10b–5.[37] Thus, the court felt that a reexamination of the due diligence defense was in order following the Supreme Court's holding in *Hochfelder*.[38]

1975), the Second Circuit held that the antifraud provisions of federal securities laws and accompanying rules would apply to:

1. [R]esident Americans whether or not any acts or culpable omissions of material importance occurred in the United States;
2. Americans resident abroad only for acts or culpable omissions within the United States which significantly contributed to the loss; and
3. [F]oreigners outside the United States only if the proscribed conduct within this country directly caused the loss.

Id. at 993.

The Third Circuit relied upon the more traditional formulation of section 17 of *Restatement (Second) of Foreign Relations Law of the United States*, which provides:

> A state has jurisdiction to prescribe a rule of law
>
> (a) attaching legal consequences to conduct that occurs within its territory, whether or not such consequences are determined by the effects of the conduct outside the territory, and
>
> (b) relating to a thing located, or a status or other interest localized, in its territory.

RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 17 (1965).

The court stated that the consideration may simply be one of policy: "Moreover, on policy grounds, the interest of the United States in regulating the conduct of its broker-dealers in this country and enhancing world confidence in its securities market is ample justification for applying the securities laws." 540 F.2d 595, *citing* Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326, 1334–35 (2d Cir. 1972). The court also noted that *Straub* did not present a "predominantly foreign transaction[:]" "The fraudulent scheme was conceived in the United States by American citizens, involved stock in an American corporation traded on American over-the-counter exchange, and an American securities broker from his office in New Jersey was responsible for the wrongful omissions." 540 F.2d at 595; *cf.* IIT v. Vencap, Ltd., 519 F.2d 1001 (2d Cir. 1975) (jurisdiction found where United States was used as a base for manufacture of fraudulent security devices for export). *See generally* Note, *American Adjudication of Transnational Securities Fraud*, 89 HARV. L. REV. 553 (1976).

After disposing of the jurisdictional issue, the court turned to defendant's argument that VaisCo was not liable. The court affirmed the findings of liability on the part of VaisCo as a "controlling person" under section 20(a) of the 1934 Act, 15 U.S.C. § 78t(a) (1970). 540 F.2d at 595–96. Section 20(a) provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t(a) (1970).

In Rochez Bros. v. Rhoades, 527 F.2d 880 (3d Cir. 1975), the Third Circuit delimited the liability of a corporation under section 20(a), adopting a test requiring that the plaintiff show culpable participation by the control person before liability is imputed to him under section 20(a). *Id.* at 885, *citing* Lanza v. Drexel & Co., 479 F.2d 1277, 1299 (2d Cir. 1973). The *Straub* court found liability under this test on the basis of VaisCo's "active participation in the scheme, its receipt of the benefits, and its status as a broker-dealer." 540 F.2d at 596.

37. 540 F.2d at 597. The court found that analysis of the elements of common law deceit and misrepresentation was relevant but not determinative in the interpretation of rule 10b–5. *Id., citing* Blue Chips Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), *and* Landy v. FDIC, 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

38. 540 F.2d at 597.

In undertaking this reexamination, the court viewed the common law as "relevant"[39] and observed that under the common law "once the right to recover for intentional misrepresentation has been established, lack of care on the part of the recipient in accepting the representation as true becomes irrelevant so long as the misrepresentation is not patently false."[40] Moreover, the court noted that even where negligence is the basis of tort liability, the developing doctrine of comparative negligence militates against making the plaintiff's failure to exercise due care a complete bar to recovery.[41] In view of these fundamental tort principles, the court ruled that the analogy between the common law of deceit and rule 10b–5 required that the due diligence defense be "narrowly circumscribed."[42]

The court, however, was not willing to use these tort concepts as a rationale for eliminating the due diligence defense altogether; rather, it stated that "tort concepts must be balanced against the policies underlying the federal securities laws and the judicially credited causes of action."[43] Finding that the availability of the due diligence defense would serve the important policy of encouraging investor caution,[44] the court ruled that if a plaintiff did not act with reasonable care under the circumstances at issue, this would be a bar to recovery under rule 10b–5.[45] Nevertheless, the court ruled that the burden of proof on the issue of the plaintiff's diligence was

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39. *Id.*

40. *Id.* at 597.

41. *Id.*

42. *Id.*; see note 58 *infra*.

43. 540 F.2d at 597.

44. *Id.* at 598. The court referred to the "deterence of investor carelessness" and the "encourag[ement of] investor caution." *Id.* at 597–98.

45. *Id.* at 598. The court stated that factors such a "fiduciary relationship, opportunity to detect the fraud, sophistication of the plaintiff, the existence of longstanding business or personal relationships, and access to the relevant information" may be considered in determining whether plaintiff's actions were reasonable. *Id.*

The court also pointed out that even though a showing of due care will depend in part upon plaintiff's level of knowledge of investments in general, a so-called "sophisticated investor" — one whose knowledge and experience are far greater than average — will not be barred from recovery simply by reliance upon defendant's statements absent readily obtainable knowledge that defendants are not to be trusted. *Id.* As to the question of a test to determine whether a particular plaintiff has such knowledge, it has been said that "[w]hen the problem is framed in terms of the plaintiff's obligation to exercise due care, the plaintiff's own expertise and knowledge are ready criteria for measuring the particulars of that duty." Wheeler, *supra* note 17 at 600. *See also* Mann, *Rule 10b–5: Evaluation of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter*, 45 N.Y.U. L. REV. 1206 (1970); Comment, *Negligent Misrepresentations Under Rule 10b–5*, 32 U. Chi. L. Rev. 824 (1965). Encouraging investor care in securities transactions may result in the detection of fraud by the investor himself at the inception of the transaction. This view is evidenced by pre-*Hochfelder* cases holding that a plaintiff must exercise due care even if the defendant acted intentionally. *See* Clement A. Evans & Co. v. McAlpine, 434 F.2d 100. For the facts and holding of *McAlpine, see* note 23 *supra*. One commentator suggested, however, that the decision in *McAlpine* may have been influenced by the substantive law of Georgia, the state in which the cause of action arose. Wheeler, *supra* note 17, at 582 n. 65. Georgia law, of which the court apparently was aware, 434 F.2d at 103, provides that the plaintiff's carelessness is a defense even to deliberate misrepresentation. Wheeler, *supra* note 17 at 582 n. 65. *citing* United

squarely on the defendant since the due diligence defense was affirmative in nature.[46]

In applying its holding to the facts of the instant case, the *Straub* court held that plaintiff's conduct had been within the "permissible zone" of due diligence in light of the circumstances surrounding the transaction.[47] Rejecting the defendant's argument that the fact that plaintiff was a sophisticated investor made his bare reliance on defendant's statements per se unreasonable,[48] the court declared that "a sophisticated investor is not barred by reliance on the honesty of those with whom he deals in the absence of knowledge that the trust is misplaced."[49] Finding that the plaintiff's trust in the defendant's integrity was reasonable by virtue of the confidential relationship between them, and that the defendant had abused this confidence,[50] the court affirmed the lower court's finding of liability.[51]

The major issue which confronted the court in *Straub* was whether *Hochfelder's* introduction of scienter into the 10b–5 cause of action dictated the elimination of the due diligence defense.[52] As the court itself pointed out, the due diligence defense was developed in the federal courts through an express analogy to contributory negligence.[53] Therefore, the denial of recovery against a defendant who negligently misrepresented certain facts where the plaintiff has failed to exercise reasonable care for his own protection was a position firmly supported in American jurisprudence.[54] However, the theory that lack of reasonable care can operate as a defense to liability for the intentional infliction of harm does not find support at

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States v. Northeast Constr. Co., 298 F. Supp. 1135 (S.D. Ga. 1969); A.M. Kidder & Co. v. Clement A. Evans & Co., 111 Ga. App. 484, 142 S.E.2d 269 (1965).

Although the defendants' conduct could probably be characterized as intentional in many of the instances in which the requirement has been found, Wheeler, *supra* note 17, at 581–82, most of these cases have omitted discussion of the effect of a finding of intentionally fraudulent acts on the part of defendant upon the due diligence requirement. *Id.* at 579. One case which addressed this point is Carroll v. First Nat'l Bank, 413 F.2d 353 (7th Cir. 1969), *cert. denied,* 396 U.S. 1003 (1970); *see* note 23 *supra.*

However, an argument for elimination of the requirement, especially in light of *Hochfelder,* is presented by Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976); *see* note 33 *supra.*

46. 540 F.2d at 598.

47. *Id.* Finding that Vaisman knew that it was unlikely that Straub would investigate Erb's recommendation, the court found Vaisman to have abused the confidence that Straub had in Erb. *Id.* It noted that Straub did not have access to Mark I Offset's plans to file for bankruptcy. *Id.* Further, the defendants were found to have planned the transaction to take place during the year-end holiday season, which allowed only limited opportunity for investigation. *Id.*

48. *Id.*

49. *Id.*

50. *Id; see* note 47 *supra.*

51. 540 F.2d at 598.

52. *See* notes 29–31 and accompanying text *supra.*

53. *Id.* at 597; *see* notes 20 & 21 and accompanying text *supra.*

54. W. PROSSER, *supra* note 30, § 107, at 699. However, a "substantial minority" of American jurisdictions refuse to follow this rule, and many courts that purport to do so have in fact allowed recovery for misrepresentations less than intentional. *Id.* at 700.

common law.[55] Since, under *Hockfelder*, the private 10b–5 cause of action is now of the nature of an intentional tort,[56] it would seem that the analogy to the common law which fostered the development of the due diligence defense in the first instance would call for the elimination of that defense.

The *Straub* court recognized this logic and the conclusion inherent in it. Nevertheless, the court's ruling left the due diligence defense still available to a 10b–5 defendant.[57] The only rationale offered by the court to support its departure from the common law was its own notions of public policy. In looking to the federal securities statutes and the judicial gloss which has been place upon them, the court discerned a policy in favor of encouraging "watchfulness in the marketplace."[58] However, the court failed to cite any specific sources from which such a policy could be derived.[59] It is submitted that the court's failure on this point is a result of the fact that the federal securities laws generally, and section 10 specifically, do not in fact express any policy of encouraging investor watchfulness.[60] Indeed, the thrust of the law is to the contrary, for the securities laws were passed in order to protect public investors from the unscrupulous practices against which Congress felt they were unable to guard by themselves.[61] Hence, while the policy of encouraging investor caution might be desirable, it is certainly not found in the federal statutes or in their legislative history.[62]

Even assuming that a court may legitimately find such a policy and condition private recovery upon the exercise of behavior which conforms to that policy, it is submitted that the *Straub* holding is still unjustifiable. The securities laws express a strong policy in favor of protecting investors.[63] Indeed, this was why the courts allowed private recovery under rule 10b–5 in the first place.[64] Where the plaintiff and defendant are of equal fault in a securities transaction conducted on the basis of inadequate information, the policy of encouraging investor caution, coupled with the traditional common

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55. *Id.* § 108, at 716; *see* note 30 *supra.*

56. *See* note 28 *supra.*

57. 540 F.2d at 598.

58. *Id.* at 597. The court found additional support for its conclusions through a consideration of the policy of protecting the integrity of the marketplace. *Id.* The court stated that "[i]ntegrity is still the mainstay of commerce and makes it possible for an almost limitless number of transactions to take place without resort to the courts." *Id.* at 598. The 10b–5 private remedy was implied by the judiciary at least partly because the SEC could not be expected to seek a public remedy for each of the large and growing number of claimed violations of the rule. Rule 10b–5 was not intended to be "an insurance policy for foolish investors." Note, *supra* note 20, at 606.

59. 540 F.2d at 598.

60. *See* note 12 *supra.*

61. Section 2 of the 1934 Act states:

> [T]ransactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto . . . in order to insure the maintenance of fair and honest markets in such transactions. . . .

15 U.S.C. § 78b (1970).

62. *See* Wheeler, note 17, *supra* at 600 & nn.13–17.

63. *See* note 61 *supra.*

64. *See* note 19 *supra* and authorities cited therein.

law concepts of contributory negligence, may be of sufficient force to justify denying a public investor the protection given to him by the securities acts. However, where the defendant knowingly defrauds a plaintiff, it is not only against the spirit of the securities laws, but also against the history of American jurisprudence to allow the defense that the plaintiff should have known that the defendant was cheating him. Here, the policy of encouraging watchfulness should yield to the stronger policy of protecting investors from fraudulent securities transactions.

Notwithstanding these flaws in the logic of the *Straub* opinion, the court's decision can be read as having substantially constricted the nature and availability of the due diligence defense so as to comply more nearly with the common law of fraud and the spirit of the securities laws. This conclusion is supported by the court's holding that an investor, even a "sophisticated investor," is entitled to rely upon the honesty of those with whom he deals in the absence of *knowledge* that the trust is misplaced.[65] This holding is tantamount to saying that any investor exercises reasonable care when he enters into a securities transaction *unless* he has knowledge of the facts not disclosed to him or knowledge that the person representing these facts is not to be trusted. Hence, although the *Straub* court couched its due diligence test in terms of whether the plaintiff acted reasonably under the circumstances,[66] it is apparent that the test employed was whether the plaintiff had justifiably relied upon the representations made to him. Such an analysis of the *Straub* holding would bring the court's decision in line with the Tenth Circuit's position in *Holdsworth*.[67] However, the *Straub* decision is highly ambiguous on this point and the issue must await further clarification.

Straub is significant in that it recognizes the due diligence defense as viable, even after *Hochfelder*. Thus, the impact of *Straub* lies in its maintenance, in somewhat modified form, of the existing elements of a private action under rule 10b–5. Those who choose to litigate such matters in the Third Circuit will be required to meet the vague and ambiguous standards of proof as to due diligence set forth by that court. In light of the Tenth Circuit's elimination of the due diligence element in *Holdsworth*, *Straub* has created a significant split among the circuits concerning an issue extremely important to litigants because of the questions of proof involved. The issue is thus ripe for resolution by the Supreme Court.

Harold Rosen

65. 540 F.2d at 598.
66. 540 F.2d at 598.
67. *See* note 32 *supra*.

ANTITRUST LAW — TYING ARRANGEMENTS — CLASS ACTIONS — WHERE AN ACTION ALLEGING AN ILLEGAL TYING ARRANGEMENT IS BROUGHT AGAINST A FRANCHISOR BY ITS FRANCHISEES, THE FRANCHISEES MUST INDIVIDUALLY PROVE THAT THEY WERE COERCED INTO TAKING THE TIED PRODUCT, THEREBY PRECLUDING A CLASS ACTION.

Ungar v. Dunkin' Donuts of America, Inc. (1976)

Plaintiffs, a group of franchisees, filed suit[1] against their franchisor, Dunkin' Donuts, alleging that Dunkin' Donuts granted their franchises only upon the condition that the franchisees also purchase other items,[2] and that this requirement constituted an illegal tying arrangement[3] prohibited by section 1 of the Sherman Act (section 1).[4] The plaintiffs sought class action status under subsections (2) and (3) of Federal Rule of Civil Procedure 23(b).[5]

1. Two actions seeking damages as well as declaratory and injunctive relief were filed against Dunkin' Donuts in 1972 in the United States District Court for the Eastern District of Pennsylvania and were consolidated for trial. Ungar v. Dunkin' Donuts of America, Inc., 531 F.2d 1211, 1214 (3d Cir), *cert. denied,* 429 U.S. 823 (1976). One of the cases, Ungar v. Dunkin' Donuts of America, Inc., stemmed from the standard form contract in effect from 1967 until November 1, 1970, which made it a prerequisite to the franchise arrangement that the franchisee enter into an agreement to buy his equipment package from Dunkin' Donuts. Ungar v. Dunkin' Donuts of America, Inc., 68 F.R.D. 65, 80 (E.D. Pa. 1975). The other case, Radar v. Dunkin' Donuts, Inc., arose out of the amended contract, effect November 1, 1970, which provided that the franchisee had a 30-day option to purchase the equipment from a source other than Dunkin' Donuts. *Id.* The purpose of the 30-day option was to preclude any suit from being instituted on the ground that the contract required the purchase of equipment from Dunkin' Donuts and was thus an illegal tying arrangement. *See* 531 F.2d at 1215–16.

2. 531 F.2d at 1214. Dunkin' Donuts, the largest coffee and doughnut franchise system in the country, entered into franchise agreements with each of its franchisees whereby it selected the site, built a doughnut shop, offered the prospective franchisee a lease on the land and building, and offered to sell him the equipment needed to operate the shop. *Id.* The described procedure, which is typical of franchise operations, is called a "turn-key" operation since the franchisee need only turn the key to be in business. *Id.* The ability of the franchisor to provide the franchisee with such an operation is indicative of its power over the franchisee. *Id.* at 1223.

3. A tying arrangement is "an agreement by a party to sell one product but only on the condition that the buyer also purchases a different (or tied) product, or at least agrees that he will not purchase that product from any other supplier." Northern Pac. Ry. v. United States, 356 U.S. 1, 5–6 (1958) (footnote omitted).

Specifically, the franchisees contended that four kinds of items were tied to the Dunkin' Donuts trademark — the alleged tying product: real estate, equipment, signs, and supplies. 531 F.2d at 1215. They asserted that threats of disenfranchisement exerted substantial pressure on them to retain vendors selected by Dunkin' Donuts. 68 F.R.D. at 81. On appeal, they stressed that the absence of express contractual tying provisions could have no importance if illegal tying could be established in other ways. 531 F.2d at 1216. The focus of their case was not on individual instances of illegal conduct, but rather "a pervasive company policy, 'firm and resolutely enforced'" by Dunkin' Donuts, to tie the specified items to the trademark license. *Id.*

4. Section 1 provides in pertinent part: "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal . . . ." 15 U.S.C. § 1 (1970).

5. Rule 23 reads in pertinent part:

(a) Prerequisites to a Class Action. One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so

Determining that it was not necessary for each franchisee to prove that he was individually coerced by the franchisor into purchasing the tied items, the district court concluded that common questions of law and fact predominated over individual ones and granted certification of the class.[6] After permitting an interlocutory appeal,[7] the Court of Appeals for the Third Circuit[8] reversed and remanded for individual trials, *holding* that the district court's class certification with respect to the tying claim, insofar as it was expressly premised upon its rejection of the individual coercion doctrine, should not have been granted because proof of individual coercion is essential to establishing a prima facie case of illegal tying absent an express contractual tie-in. *Ungar v. Dunkin' Donuts of America, Inc.*, 531 F.2d 1211 (3d Cir.), *cert. denied*, 429 U.S. 823 (1976).

The role which coercion has played in previous tying arrangement cases is unclear. Historically, the Supreme Court has not spoken expressly in terms of an individual coercion doctrine; rather, it has focused upon the degree of economic power required to find an illegal tie. In *International Salt Co. v. United States*,[9] the Supreme Court essentially held that ownership of a patent conclusively showed market dominance, so that if, as a prerequisite

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numerous that joinder of all members is impractical, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

(b) Class Actions Maintainable. An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:

. . . .

(2) the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or

(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other methods for the fair and efficient adjudication of the controversy.

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Appellant denied the existence of any tie-ins and argued that even an assumption of illegality would not permit certification of a class, because the absence of any express contractual tying provisions precluded a finding of any common issues. 531 F.2d at 1216. Appellants claimed that individual questions predominated. *Id.* at 1216–17.

6. 68 F.R.D. at 141. According to the district court, "[t]he individual coercion doctrine . . . appears to require proof by the plaintiff of such events and circumstances surrounding the relationship between the franchisor and *each* franchisee as will demonstrate that the franchisee was *coerced* into agreeing to an anticompetitive tie, usually of equipment or supplies." *Id.* at 78 (emphasis supplied by the court). Had the district court accepted the individual coercion doctrine, individual questions of fact and law would have predominated, and a class action would have been precluded.

7. 531 F.2d at 1214. The circuit court accepted the interlocutory appeal because it involved the question of the district court's rejection of the individual coercion doctrine, which had been adopted by many other district courts. *Id.* The court thus focused its discussion upon the propriety of that rejection. *Id.*

8. The case was heard by Judges Aldisert, Garth, and Hunter. Judge Aldisert wrote the opinion.

9. 332 U.S. 392 (1947). The Government brought an action under section 1 of the Sherman Act, 15 U.S.C. § 1 (1970), and section 3 of the Clayton Act, *id.* § 14, to enjoin the International Salt Company from enforcing provisions of the leases of its

to leasing a patented machine, a lessee had to purchase other products from the lessor, a violation of section 1 was proved.[10]

Six years later, in *Times-Picayune Publishing Co. v. United States*,[11] the Court temporarily narrowed the scope of illegality of tying by requiring that the seller enjoy a monopolistic position in the market for the tying product.[12] Significantly, *Times-Picayune* arguably marked the genesis of the individual coercion doctrine. According to the Court, "[b]y conditioning his sale of one commodity on the purchase of another, a seller *coerces* abdication of buyers' independent judgment as to the 'tied' product's merits and insulates it from the competitive stresses of the open market."[13] The Court found further that "[t]he common core of the adjudicated unlawful tying arrangement is the *forced* purchase of a second distinct commodity with the desired purchase of a dominant 'tying' product . . . ."[14] Subsequently, in *United States v. Loew's Inc.*,[15] a 1962 decision involving block-booking of films in

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patented machines which required lessees to use only International Salt's products. 332 U.S. at 393. In affirming the lower court's granting of summary judgment for the Government, the Supreme Court held:

> The appellant's patents confer a limited monopoly of the invention they reward. . . . But the patents confer no right to restrain use of, or trade in, unpatented salt. By contracting to close this market for salt against competition, International has engaged in a restraint of trade which its patents afford no immunity from the antitrust laws.

Id. at 395–96 (citations omitted).

10. 332 U.S. 392 (1947). Various commentators have suggested that if the Court consciously assumed that competing products were available, it was saying that dominance would be presumed on a mere showing that the tying product had some element of distinctiveness. Turner, *The Validity of Tying Arrangements Under the Antitrust Laws*, 72 HARV. L. REV. 50, 53 (1958); *see* Comment, *Antitrust Barriers to Franchising*, 61 GEO. L.J. 189, 194 (1972).

11. 345 U.S. 594 (1953). The Times-Picayune Publishing Company, which owned a morning and an evening paper in New Orleans, required all advertisers to purchase space in both papers as a unit. *Id.* at 596–97. The Government filed suit challenging these "forced combination" contracts as unreasonable restraints of interstate trade in violation of section 1 of the Sherman Act. *Id.* In reversing the district court's enjoining of these unit contracts, the Supreme Court, finding no monopolistic position in the market for the tying product, stated:

> From the "tying" cases a perceptible pattern of illegality emerges: When the seller enjoys a monopolistic position in the market for the "tying" product, *or* if a substantial volume of commerce in the "tied" product is restrained, a tying arrangement violates the narrower standards expressed in § 3 of the Clayton Act because from either factor the requisite potential lessening of competition is inferred. And because for even a lawful monopolist it is "unreasonable, *per se*, to foreclose competitors from any substantial market," a tying arrangement is banned by § 1 of the Sherman Act whenever *both* conditions are met.

Id. at 609 (footnote omitted).

12. *Id.* at 608–09; *see* McCarthy, *Trademark Franchising and Antitrust: The Trouble with Tie-ins*, 58 CALIF. L. REV. 1085, 1096 (1970); Turner, *supra* note 10, at 54. The narrowing was only temporary because subsequently, in Northern Pac. Ry. v. United States, 356 U.S. 1 (1958), the Supreme Court construed the "monopoly power" language of *Times-Picayune* as requiring nothing "more than sufficient economic power to impose an appreciable restraint on free competition in the tied product." *Id.* at 11.

13. 345 U.S. at 605 (emphasis added).

14. *Id.* at 614 (emphasis added).

15. 371 U.S. 38 (1962).

sales to television stations,[16] the Court refined the economic power test by holding that even absent market dominance, the requisite economic power was inferrable from the desirability or uniqueness of the tying product.[17] The Court also stated that this economic power would be presumed when the tying product was patented or copyrighted.[18] Moreover, the Court noted that because "[t]elevision stations [were] *forced* to take unwanted films, [they were thereby] denied access to films marketed by other distributors . . . ."[19]

While the Supreme Court has never characterized the coercion doctrine as such, numerous lower federal courts have expressly required proof of coercion as an element of an illegal tying arrangement.[20] For example, the Second Circuit, in *American Manufacturers Mutual Insurance Co. v. American Broadcasting-Paramount Theatres*,[21] stated that "there can be no illegal tie unless unlawful coercion by the seller influences the buyer's choice."[22] Shortly thereafter, however, the Ninth Circuit, in *Siegel v. Chicken Delight, Inc.*,[23] equated a trademark with a patent or copyright —

16. In selling motion pictures to television stations, the defendant film distributors were conditioning the sale of feature films upon the purchase of a package containing one or more unwanted or inferior films. *Id.* at 40. The district court found a violation of section 1 of the Sherman Act. *Id.* Relying upon *International Salt* and *Times-Picayune,* the Supreme Court affirmed, finding "economic leverage, inherent in the copyright, sufficient to induce [the seller's] customers to take the tied product along with the tying item." *Id.* at 45.

17. *Id.*

18. *Id.*

19. *Id.* at 49.

20. *See, e.g.,* Halverson v. Convenient Food Mart, Inc., 69 F.R.D. 331 (N.D. Ill. 1975); Thompson v. T.F.I. Cos., 64 F.R.D. 140 (N.D. Ill. 1974); Smith v. Denny's Restaurants, Inc., 62 F.R.D. 459 (N.D. Cal. 1974); E.B.E., Inc. v. Dunkin' Donuts of America, Inc., [1975] 1 Trade Cas. ¶60,266 (E.D. Mich., July 24, 1974); Bogosian v. Gulf Oil Corp., 62 F.R.D. 124 (E.D. Pa. 1973); *In re* 7-Eleven Franchise Antitrust Litigation, [1972] Trade Cas. ¶74,156 (N.D. Cal. 1972); Capital Temporaries, Inc. v. Olsten Corp., 365 F. Supp. 888 (D. Conn. 1973), *aff'd,* 506 F.2d 658 (2d Cir. 1974); Abercrombie v. Lum's, Inc., 345 F. Supp. 387 (S.D. Fla. 1972).

21. 446 F.2d 1131 (2d Cir. 1971), *cert. denied,* 404 U.S. 1063 (1972). In this case an action was brought by American Broadcasting-Paramount Theatres, Inc. (ABC) against The Kemper Insurance Companies (Kemper) alleging Kemper's failure to adhere to a contract which bound Kemper to sponsor ABC's "Evening Report." 466 F.2d at 1132. Kemper raised the defense that the contract constituted an illegal tying arrangement. *Id.* By the terms of the contract, Kemper was bound to sponsor the show on 95 stations, including 28 on which Kemper allegedly did not wish to advertise. *Id.* at 1134. The district court struck this defense and Kemper appealed. *Id.* at 1133–34. Affirming the dismissal of the antitrust claim, the court of appeals held that insofar as Kemper failed to "persevere long enough with its ideal lineup [of 67 stations] to feel any economic pressure from ABC," a substantial quantity of business to competitors was not foreclosed. *Id.* at 1137.

22. *Id.* The court neither defined the term "unlawful coercion" nor cited any authority in support of its statement. *Id.*

23. 448 F.2d 43 (9th Cir. 1971), *cert. denied,* 405 U.S. 955 (1972). A treble damage class action was brought against Chicken Delight by certain franchisees who sought damages for injuries allegedly resulting from an illegal tie-in imposed by Chicken Delight's standard form franchise agreement. 448 F.2d at 46. Specifically, the franchisees were required to purchase certain cooking equipment, food items, and packaging directly from Chicken Delight as a condition of obtaining the trademark license. *Id.* The district court found the arrangement to constitute a per se unlawful tying arrangement. *Id.* Finding all the elements of an unlawful tying arrangement present (*see* note 38 *infra*), the court of appeals affirmed. 448 F.2d at 52.

thus inferring sufficient economic power to bring the case within the Sherman Act[24] — and found an illegal tie without mentioning coercion.[25]

In reaching the instant decision, the Third Circuit, faced with the conflicting results of previous tying cases, focused upon the rationale underlying the district court's rejection of the individual coercion doctrine.[26] The court disagreed with the district court's holding on two grounds. First, the court differed with the district court's view that the Supreme Court had not set forth a coercion requirement. Determining that the Supreme Court had done so in several cases,[27] the Third Circuit stated that "coercion is implicit — both logically and linguistically — in the concept of leverage upon which the illegality of tying is premised: the seller with market power in one market uses that power as a 'lever' to force acceptance of his product in another market."[28]

Second, the court took issue with the district court's reliance upon two Supreme Court tying cases, *FTC v. Texaco Inc.*,[29] and *Perma Life Mufflers, Inc. v. International Parts Corp.*[30] In *Texaco,* Texaco agreed with Goodrich to induce its dealers to purchase Goodrich tires, batteries, and accessories in

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24. 448 F.2d at 50. The court concluded: "Accordingly we see no reason why the presumption that exists in the case of the patent and copyright does not equally apply to the trademark." *Id.* (footnote omitted); *see* text accompanying note 18 *supra.* One commentator subsequently observed that "the uniqueness-distinctiveness test affects franchising through the concept of the trademark since trademarked products . . . are by definition distinctive." Comment, *supra* note 10, at 195.

25. 448 F.2d at 52.

26. Due to the nature of the issue and the exhaustive treatment given the subject by Judge Becker in the district court decision, Judge Aldisert noted that the "question subsumes review of the district court's conclusions as to the proof requisite to establish an illegal tie-in," and directed his analysis primarily to the lower court opinion rather than to the contentions made by the parties. 531 F.2d at 1215.

27. Examining Times-Picayune Publishing Co. v. United States, 345 U.S. 594 (1953), and Northern Pac. Ry. v. United States, 356 U.S. 1 (1958), the court found no ambiguity in the Supreme Court's language on this point. The Third Circuit quoted the following passage from *Northern Pacific:*

> [Tying arrangements] deny competitors free access to the market for the tied product, not because the party imposing the tying requirements has a better product or a lower price but because of his power or leverage in another market. At the same time buyers are forced to forego their free choice between competing products.

531 F.2d at 1218–19, *quoting* Northern Pac. Ry. v. United States, 356 U.S. 1, 5–6 (1958). The court also relied upon similar language found in United States v. Loew's Inc., 371 U.S. 38 (1962) (*see* text accompanying note 19 *supra*), and Fortner Enterprises, Inc. v. United States Steel Corp., 394 U.S. 495 (1969). The Court in *Fortner* had concluded:

> [D]espite the freedom of some or many buyers from the seller's power, other buyers — whether few or many, whether scattered throughout the market or part of some group within the market — can be *forced* to accept the higher price because of their stronger preferences for the product, and the seller could therefore choose instead to *force* them to accept a tying arrangement that would prevent free competition for their patronage in the market for the tied product. Accordingly, the proper focus of concern is whether the seller has the power to raise prices, or impose other burdensome terms such as a tie-in, with respect to any appreciable number of buyers within the market.

394 U.S. 503–04 (emphasis added).

28. 531 F.2d at 1218.

29. 393 U.S. 223 (1968).

30. 392 U.S. 134 (1968).

return for a commission paid by Goodrich to Texaco.[31] The district court had concluded that "*Texaco* holds that proof of use of economic power . . . does not require evidence of coercion, but rather that evidence of persuasion or influence will suffice where there is dominance in bargaining power of a franchisor over a franchisee, or . . . where there is evidence of an inherently coercive marketing system."[32] The court of appeals, however, distinguished *Texaco* from *Dunkin' Donuts* on the basis that *Texaco* was decided under section 5 of the Federal Trade Commission Act (FTC Act),[33] which is much broader in its coverage than section 1 of the Sherman Act,[34] and that the legal focus of *Texaco* was not upon the relationship between Texaco and its dealers, but rather upon the Texaco-Goodrich agreement.[35]

The circuit court also found no support for the district court's view that *Perma Life* had emasculated the individual coercion doctrine.[36] The district court had apparently reasoned that *Perma Life* allowed franchisees to bring a civil damage action against the franchisor even without coercion. According to the Third Circuit, however, the Supreme Court in *Perma Life* had not even considered the individual coercion doctrine. In addition, the circuit court perhaps implicitly argued that there was in fact coercion in *Perma Life* insofar as the franchisees' participation in the *Perma Life* scheme was "not voluntary in any meaningful sense."[37]

In contrast to the holding of the district court, the Third Circuit stressed that proof that the conduct in question is a tie-in is one element of a per se

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31. 393 U.S. at 224.

32. 68 F.R.D. at 108–109.

33. 15 U.S.C. § 45 (1970).

34. Section 5 of the FTC Act proscribes conduct not proscribed by the antitrust laws. 531 F.2d at 1220. According to the court: "'[T]he Federal Trade Commission does not arrogate excessive power to itself if, in measuring a practice against the elusive, but congressionally mandated standard of fairness, it, like a court of equity, considers public values beyond simply those enshrined in the letter or encompassed in the spirit of the antitrust laws.'" *Id.*, *quoting* FTC v. Sperry & Hutchinson Co., 405 U.S. 233, 244 (1972).

The court was also concerned that since *Texaco* was an enforcement proceeding, the principle of judicial deference to administrative expertise had been applied. 531 F.2d at 1220. The court quoted directly from *Texaco* in this regard: "'[T]he determinations of the Commission, an expert body charged with the practical application of the statute, are entitled to great weight.'" 531 F.2d at 1220, *quoting* FTC v. Texaco Inc., 393 U.S. 223, 226 (1968).

35. 531 F.2d at 1220–21. Opining that this final distinction was fundamental, the court stated: "The issue was whether Texaco and Goodrich engaged in unfair competitive practices vis-à-vis Goodrich's competitors. That is a very different issue from the issue whether a franchisor is engaged in illegal tying vis-à-vis its franchisees." *Id.* (footnote omitted). Noting that the essence of the illegality of a tie-in is that it forecloses competition in the tied product market, the court distinguished between an action concerning the franchisee-franchisor relationship and an action concerning the relationship between a franchisor and competing suppliers of the franchisee market. *Id.* at 1221 n.7a.

36. *Id.* at 1221.

37. *Id.*, *quoting* Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 131, 139–40 (1968). Under the *Perma Life* scheme, the franchisees were required to sell other Midas products so that they could have the right to sell Midas mufflers. *Id.* at 137. Although the franchisor in *Perma Life* contended that its franchisees "had voluntarily, if not eagerly, participated in the tying scheme" to their benefit, 68 F.R.D. at 110, the court stated that their participation could not have been voluntary in any

illegal tie-in,[38] and that in the absence of a formal agreement, this can be proved by showing coercion.[39] Interpreting the district court's formulation[40] as requiring only proof of salesmanship by a franchisor with dominant economic power over a franchisee, the court reasoned that the practical effect of such a test would be to substitute proof of economic power for proof of the tie-in.[41]

According to the circuit court, under the district court's theory a class of franchisees could prove a per se illegal tie merely by establishing: 1) the franchisor's economic dominance; 2) the franchisor's offer and sale of more than one product to its franchisees; and 3) the existence of a policy to persuade franchisees to buy its products.[42] The circuit court found this position unsupportable because these factors are inherent in any franchise arrangement.[43] For the same reason, the court also rejected the district court's alternative test, which allowed "illegal use of economic power to be inferred from proof of 'acceptance by large numbers of buyers of a burdensome or uneconomic tie.' "[44] The circuit court reasoned that "this test would render prima facie illegal virtually every franchise system involving

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meaningful sense and that, therefore, the doctrine of *in pari delicto* did not apply. *Id.* The Third Circuit quoted the following passage from *Perma Life*:

> [P]etitioner['s] . . . participation was *not voluntary* in any meaningful sense. They sought the franchises enthusiastically but they did not actively seek each and every clause of the agreement. Rather, many of the clauses were quite clearly detrimental to their interests, and they alleged that they had continually objected to them. Petitioners apparently accepted many of these restraints solely because their acquiescence was necessary to obtain an otherwise attractive business opportunity . . . . Moreover . . ., they cannot be blamed for seeking to minimize the disadvantages of the agreement once they had been *forced* to accept its more onerous terms as a condition of doing business.

531 F.2d at 1221 (emphasis supplied by the court), *quoting* Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134, 139–40 (1968). The court also reasoned that if participation in the scheme barred a franchisee from suing, no action could ever be maintained against a franchisor by a franchisee. 531 F.2d at 1221.

38. 531 F.2d at 1223–24. In Northern Pac. Ry. v. United States, 356 U.S. 1 (1958), the Supreme Court identified three elements of a per se illegal tie-in: 1) the existence of a tie-in (*see* note 3 *supra*); 2) sufficient economic power in the seller with respect to the tying product to appreciably restrain free competition in the market for the tied product; and 3) a "not insubstantial" amount of interstate commerce must be affected. 356 U.S. at 5–6.

39. 531 F.2d at 1224.

40. *See* text accompanying note 32 *supra.*

41. 531 F.2d at 1224. The court concluded that "[p]roof of economic power must, perforce, focus on the seller; but proof of a tie-in must focus on the buyer, because a voluntary purchase of two products is simply not a tie-in." *Id.*

42. *Id.*

43. *Id.* at 1224–25. On the franchisor's market dominance, the circuit court noted that although an advantage to the franchisor, the degree of bargaining power over its franchisees is one of the basic problems in the franchise system. This power has been the source of such abuses as arbitrary franchise terminations and fraudulent promotional schemes. It may also be possible that franchisees have used the existence of this power to gain sympathy from courts where the franchisor is guilty of nothing more than enforcing an obligation which the now-successful franchisee feels to be burdensome. 531 F.2d at 1223.

44. *Id.* at 1225, *quoting* Ungar v. Dunkin' Donuts of America, Inc., 68 F.R.D. 65, 115 (E.D. Pa. 1975).

'large numbers' of franchisees."[45] Rejecting the district court's basic assumption " 'that persuasion or influence may be the virtual equivalent of coercion where there is an unequal relationship between the parties,' "[46] the Third Circuit reasoned that "[i]t is only when the buyer's freedom to choose a given product is restricted that the tying doctrine comes into play: so long as the 'buyer is free to take either product by itself there is no tying problem.' "[47]

Although, as the district court noted, there was substantial ground for differing opinions as to the correctness of its holding,[48] the circuit court opinion is nevertheless subject to some criticism. A strong argument could be made that the circuit court did not accurately construe the Supreme Court's language in *Times-Picayune, Northern Pacific,* and *Loew's*, the cases upon which it relied for authority that a coercion doctrine exists.[49] For example, a close reading of the passages in *Times-Picayune,*[50] wherein the Supreme Court used the words "coerces" and "forced," does not clearly support the Third Circuit's finding that the coercion requirement is implicit in previous Supreme Court cases.[51] Rather, the language seems to indicate that the Court was condemning the conditioning of the sale of one product upon the purchase of another, as opposed to requiring coercion of the buyer. Moreover, when the Court spoke of a "forced purchase,"[52] it arguably meant that because of the "conditioning," the buyer must take the second product if he wanted the first. It was not saying that the seller exerted any force upon, or applied any pressure to, the buyer.[53] What the Third Circuit should have focused upon, then, was the word "conditioning," and the manner in which it could be proved.

In rejecting the district court's "basic assumption" that persuasion may supplant coercion where there is an unequal relationship between the parties,[54] the court quoted from *Northern Pacific* to the effect that there is no tying problem "so long as 'the buyer is free to take either product by

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45. 531 F.2d at 1225. Suggesting that the district court had used circular reasoning, the court of appeals explained: "[I]f the question is whether there is a 'tie', proof that large numbers of buyers accepted a burdensome or uneconomic 'tie' is not helpful. The 'proof' assumes the answer rather than proving it." *Id.*

46. *Id.*, *quoting* Ungar v. Dunkin' Donuts of America, Inc., 68 F.R.D. 65, 115 (E.D. Pa. 1975).

47. 531 F.2d at 1226, *quoting* Northern Pac. Ry. v. United States, 356 U.S. 1, 6 n.4 (1958). The court also noted that the district court's basic fear was rooted in the difficulty of determining whether the franchisee was indeed coerced. 531 F.2d at 1225–26. The court concluded, however, that an inquiry into state of mind must be made insofar as it was "the unfortunate province of the courts to struggle with them." *Id.* at 1226.

48. 531 F.2d at 1214.

49. *See id.* at 1218–19.

50. *See* text accompanying notes 13 & 14 *supra.*

51. *See* text accompanying notes 13, 14 & 19 *supra.*

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

53. The same holds true for the use of the word "forced" in the *Northern Pacific* passage quoted by the court (*see* note 27 *supra*), as well as its use in *Fortner* (*see* note 27 *supra*) and *Loew's* (*see* text accompanying note 19 *supra*).

54. *See* text accompanying note 46 *supra.*

itself,' "[55] thus implying that coercion is necessary. This, however, appears to be an incorrect interpretation of the passage because if the seller simply will not sell both products separately, then the buyer is not "free." The point of the lower court opinion was precisely that the franchisee-buyer is not free to do so. Its disagreement with the individual coercion doctrine was that freedom may be restricted by other than overtly coercive means — *e.g.*, by persuasion coupled with dominance in bargaining power or the inherent coercion of *Texaco*[56] — a position clearly consonant with the *Northern Pacific* passage.

Also subject to scrutiny is the court's attempt to distinguish the two cases heavily relied upon by the district court — *Texaco*[57] and *Perma Life*.[58] While there is some validity in the Third Circuit's distinction between a section 1 Sherman Act violation and a section 5 FTC Act violation,[59] the lower court relied upon *Texaco* for "its teaching that dominance in bargaining power may give rise to inherent coercion"[60] — a lesson which would be applicable under the standard of either act.[61] Nor does the notion that the legal focus of that case was not upon the relationship between Texaco and its dealers undermine the value of that lesson. Texaco was not *inherently coercing* Goodrich, nor vice versa; Texaco was *inherently coercing* its dealers. That *Texaco* was analogous to an illegal tying case is clear from the *Texaco* opinion itself.[62]

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55. 531 F.2d at 1226, *quoting* Northern Pac. Ry. v. United States, 356 U.S. 1, 6 n.4 (1958).

56. *See* text accompanying note 32 *supra*.

57. *See* notes 31–35 and accompanying text *supra*.

58. *See* note 36 and accompanying text *supra*. While it distinguished *Texaco* and *Perma Life*, the Third Circuit relied upon several federal decisions suggesting that coercion was needed which had been distinguished by the district court. 531 F.2d 1219 n.7 & 1222 n.9. Because the circuit court did not address the lower court's analysis in this respect, the precedential support for the doctrine enunciated by the court has been undermined. For a list of these cases, *see* note 20 *supra*.

59. *See* text accompanying notes 33–35 *supra*. In Atlantic Ref. Co. v. FTC, 381 U.S. 357 (1965), the Supreme Court stated that "[i]t has long been recognized that there are many unfair methods of competition that do not assume the proportions of antitrust violations." *Id.* at 369.

60. 68 F.R.D. at 108; *see* Baker, *Another Look at Franchise Tie-Ins After* Texaco *and* Fortner, 14 ANTITRUST BULL. 767, 771 (1969); Kamenshine, *Competition Versus Fairness in Franchising*, 40 GEO. WASH. L. REV. 197, 204 (1971).

61. The fact that *Texaco* was an enforcement proceeding should not detract from its precedential value. Although, theoretically, this fact could make a difference insofar as the FTC Act is broader in its coverage than the Sherman Act, in *Texaco* the distinction was not significant. The Supreme Court found it clear from the record that Texaco held dominant economic power over its dealers and that this power was used in a manner which tended to foreclose competition. 393 U.S. at 226, 228–29.

62. 393 U.S. 223 (1968); *see* Austin, *The Tying Arrangement: A Critique and Some New Thoughts*, 1967 WIS. L. REV. 88, 93; McCarthy, *supra* note 12, at 1106. The Third Circuit also emphasized that the plaintiffs in the instant case were not suppliers competing with Dunkin' Donuts for the franchise market. 531 F.2d at 1221 n.7a. However, the identity of the plaintiff should have no bearing on whether or not the antitrust laws have been violated. The focus of *Texaco* was whether an illegal arrangement existed between Goodrich and Texaco, but in order to prove this, it was necessary to prove what amounted to a tying arrangement between Texaco and its dealers. *See* 393 U.S. at 226. This latter issue gave rise to the discussion of inherent coercion.

In rejecting the district court's reliance upon *Perma Life*, the court did not appear to meet the lower court's implicit argument that by allowing the franchisees in *Perma Life* the right to recover the Supreme Court was essentially deleting any coercion requirement from an illegal tying arrangement.[63] Although the circuit court quoted the passage from *Perma Life* wherein the Supreme Court characterized the petitioners' participation as "not voluntary in any meaningful sense,"[64] it did not specifically equate this passage with a finding of coercion since in its view there was no consideration of the doctrine.[65]

In addition, it is submitted that the Third Circuit may have misread the district court's argument. The court interpreted the district court as requiring only salesmanship coupled with dominant economic power over the franchisee.[66] But there exists a significant difference between salesmanship and the type of persuasion found to constitute inherent coercion in *Texaco*.[67] In this context, the plaintiffs in *Dunkin' Donuts* alleged that the pressure to retain the approved vendors was coupled with threats of disenfranchisement.[68] Moreover, as the district court queried, "what difference does it make whether the tie is articulated in the contract or can be proved at trial as having been imposed *sub silentio* through a pervasive and resolutely enforced company policy as is alleged here?"[69] Furthermore, the practical effect of the district court's formulation would not be to substitute proof of economic power for proof of a tie-in, since that court explicitly stated that *use* of the economic power would be required.[70]

The Third Circuit's holding that only a coerced tie could be illegal is subject to criticism on additional grounds. First, if, as the court implied, lack of "freedom of choice" is the cornerstone of an illegal tie-in,[71] a "voluntary," *i.e.*, non-coercive tie-in could be illegal, because if the sale of one product is conditioned upon the purchase of a second, then the buyer has no freedom of choice in the matter. He must take the second product in order to obtain the first.[72]

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63. *See* 68 F.R.D. at 110–11.

64. *See* note 37 and accompanying text *supra*.

65. 531 F.2d at 1221. It may be that the Supreme Court considered not whether the requirements of a tie-in were present, but only whether the plaintiffs should be barred by the doctrine of *in pari delicto*. *See* 392 U.S. at 140. If such was the case, *Perma Life* would not support the district court's finding that *Perma Life* emasculated the individual coercion doctrine. But the circuit court did not articulate this as its reason for rejecting the district court's reliance upon *Perma Life*.

66. 531 F.2d at 1224.

67. *See* text accompanying note 32 *supra*.

68. 68 F.R.D. at 81.

69. *Id.* at 99 (emphasis supplied). This issue of the existence of a pervasive company policy would be a common question.

70. *Id.* at 97.

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

72. That the buyer indeed wants the second product is, of course, irrelevant if the inquiry focuses upon the seller's intent. The seller does not care if the buyer is taking the tied product voluntarily. As far as he is concerned, the buyer is going to take it whether he wants it or not, or else he does not get the tying product. In the criminal law, it is necessary to look to the state of mind of the criminal. Although it is sometimes necessary to inquire as to the state of mind of the victim, as in rape cases,

Second, the policy basis underlying section 1 suggests that a voluntary tie can be illegal. By requiring that the focus be upon the buyer,[73] the circuit court has ignored harm to the competitors whom section 1 was designed to protect. The policy basis of section 1 as applied to tying arrangements has been summarized as follows:

> The Court has shown . . . concern . . . with the interest of competing suppliers of a tied product in free access to the consuming market — a strong desire that competition in the sale of each product should be "on the merits." This interest is adversely affected even though the seller's power over the tying product is slight, so slight that the buyers cannot accurately be said to be "coerced" into the tying arrangement. It takes very little power to induce buyers to enter into an agreement of the type found in *Northern Pacific* . . . . But the fact that the seller's power over the tying product is slight, and the buyers are not "coerced," does not significantly lessen the impact on competing sellers of the tied product.[74]

If the emphasis is indeed on the free market and the non-foreclosure of competition,[75] then, whether the tie is voluntary or not, the conclusion that an illegal tie has been established would follow, because the seller's competitors, who are within the scope of section 1's protection, are the ones being harmed by the tying scheme. The court's failure to recognize the policy basis of section 1 thus weakens its application in tying cases.

Even the assumption that coercion is a proper requirement of tying law would not necessarily settle the issue presented in *Dunkin' Donuts*. The court did not address the possibility that coercion could be established in such a manner that common, rather than individual, questions would predominate.[76] *Perma Life, Times-Picayune,* and *Fortner Enterprises, Inc. v. United States Steel Corp.*[77] each contain language indicating that coercion can be found from a conditioning of the sale of the first product upon the

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this should not be necessary where the harm is to others as well. For the discussion of the policy basis underlying section 1 of the Sherman Act, *see* text accompanying notes 74 & 75 *infra*.

That there may be no damages flowing from a voluntary tie should have no bearing on whether there was in fact a tie-in. And the fact that some plaintiffs may have damages, and some not, would not cause individual questions to predominate insofar as separate trials could be held on the question of damages. Siegel v. Chicken Delight, Inc., 271 F. Supp. 722, 726 (N.D. Cal. 1967), *modified sub nom.*, Chicken Delight, Inc. v. Harris, 412 F.2d 830 (9th Cir. 1969). *But see* Smith v. Denny's Restaurants, Inc., 62 F.R.D. 459, 460–61 (N.D. Cal. 1974).

73. 531 F.2d at 1224. *See* note 41 *supra*.

74. Turner, *supra* note 10, at 60–61; *see* Baker, *supra* note 60, at 777–78; Pearson, *Tying Arrangements and Antitrust Policy*, 60 NW. U.L. REV. 626, 631 (1965); Note, *Franchises, Requirements Contracts and Tie-Ins: One Test for a Tangled Two*, 74 YALE L.J. 691, 693–94 (1965). For a general outline of the policy basis underlying the Sherman Act, *see* Northern Pac. Ry. v. United States, 356 U.S. 1, 4 (1958).

75. *See* 68 F.R.D. at 112–13.

76. In finding that coercion must be established on an individual basis the court stated: "What is sufficient to coerce one buyer's choice may not be sufficient to coerce another buyer's choice; an item that one buyer might accept voluntarily, another might accept only if forced to do so." 531 F.2d at 1219.

77. 394 U.S. 495 (1969).

purchase of a second.[78] Indeed, the court quoted from the *Times-Picayune* opinion to that effect.[79] Whether there was a pervasive company policy of "conditioning" would seem to be a common question.[80]

Another possibility is that coercion might be inferred from sufficient economic power in the seller. Referring to *International Salt, Times-Picayune, Northern Pacific, Loew's*, and *Fortner*, the Court of Appeals for the Second Circuit, in *Capital Temporaries, Inc. v. Olsten Corp.*,[81] stated that "[t]he question raised in the pertinent cases is not whether coercive pressure is used but how can it be established."[82] After reviewing these cases, the Second Circuit concluded that

> the plaintiff must establish that he was the unwilling purchaser of a tied product. If he was not coerced by the economic dominance of the seller, he at least must show that he was compelled to accept the tied product by virtue of the uniqueness or desirability of the tying product, which other competitors could not or would not supply.[83]

If the question of uniqueness is to be decided by the court,[84] as it was in *Capital Temporaries*, it would appear to be a common question not requiring individual trials.

The potential impact of the instant case is difficult to ascertain because its analytical weaknesses may deter other courts from relying upon its rationale. At the same time, however, the decision may have the effect of solidifying the view taken by numerous courts that individual coercion is a requirement of tying law.[85] In those cases which do follow *Dunkin' Donuts*, the dispute will focus upon whether the franchisee has been coerced by the franchisor. Although the holding in *Dunkin' Donuts* is narrow — relating

78. *See* Fortner Enterprises, Inc. v. United States Steel Corp., 394 U.S. 495, 503–04 (1969); Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134, 140 (1968); Times-Picayune Publishing Co. v. United States, 345 U.S. 594, 605 (1953) (*see* text accompanying note 13 *supra*); Susser v. Carvel Corp., 332 F.2d 505 (2d Cir. 1964) (Lumbard, J., dissenting in part).

79. *See* 531 F.2d at 1218.

80. *See* note 3 *supra*.

81. 506 F.2d 658 (2d Cir. 1974). This case was cited by the circuit court in *Dunkin' Donuts* as requiring coercion. 531 F.2d at 1219 n.7.

82. 506 F.2d at 662. According to the Second Circuit, the coercion in *International Salt* resulted from the existence of the patented machinery; in *Times-Picayune* and *Northern Pacific*, it resulted from the seller's monopolistic position in the market for the tying product; in *Loew's* and *Fortner*, crucial economic power was derived from desirability to consumers and uniqueness in attributes. *Id.*

83. *Id.* at 663. In *Capital Temporaries*, the Second Circuit did not go as far as did the Ninth Circuit in *Siegel* (*see* notes 23–25 and accompanying text *supra*); but that is of no consequence for purposes of analyzing the case at bar. The Second Circuit specifically found that there was nothing in the record, and no claim made, that there was something so unique in the techniques of the franchisor that it could not be offered by others. 506 F.2d at 663.

84. If *Siegel* were followed, there would be no need to decide the question of uniqueness. Relying upon Susser v. Carvel Corp., 332 F.2d 505 (2d Cir. 1964), the court in *Capital Temporaries* implicitly distinguished *Siegel*. *See* 506 F.2d at 663. *Susser*, however, has been generally discredited by commentators because of its misreliance upon the market dominance test of *Times-Picayune* and *Northern Pacific*. Note, *supra* note 74, at 697; *see* Baker, *supra* note 60, at 777–78; McCarthy, *supra* note 12, at 1094.

85. For a list of the cases espousing this view, *see* note 20 *supra*.

solely to tying cases in which the terms imposing the tie-in were not delineated in a contract — it may eventually be construed to cover all franchise agreements. Because the individual coercion requirement makes it impossible for class actions to be brought, the decision may be responsible for initiating a trend away from contractual tie-ins and toward pervasive company policies,[86] thus making proof of coercion a necessity in *all* franchise cases.

While the instant decision, in the circuit court's view, saved the franchise system from ruination,[87] it is submitted that in the process it harms the franchisees by raising barriers to their entry into court and by increasing the burden upon them once they get in. Even if it were able to afford to bring an individual action,[88] the franchisee would now have to meet the more rigorous test of proving coercion instead of use of economic power. Moreover, the instant decision will result in a multiplicity of suits instead of one class action. In addition, future courts will have to define coercion and decide whether inherent, as opposed to overt, coercion will be sufficient.[89] Finally, the court must determine the state of mind of each buyer.[90]

The court's inadequate treatment of numerous aspects of the case has served only to enhance the confusion already extant in the law of tying arrangements. Even if future courts decide to follow the *Dunkin' Donuts* rationale, they will be forced to resolve the numerous problems remaining in its wake.

Thomas M. Russo

86. *See* note 3 *supra*; text accompanying note 80 *supra*.
87. 531 F.2d at 1223 n.10.
88. One commentator has stated that such persons are unable to do so. Solomon, *An Analysis of Tying Arrangements: The Offer You Can't Refuse*, 26 MERCER L. REV. 547, 553–55 (1975).
89. 531 F.2d at 1226; *see* note 47 *supra*.
90. 531 F.2d at 1221 n.7a.

CRIMINAL PROCEDURE — PROSECUTORIAL MISCONDUCT — UNNECESSARY INTIMIDATION OF DEFENSE WITNESS BY PROSECUTOR IS DENIAL OF DEFENDANT'S RIGHT TO DUE PROCESS AND A FAIR TRIAL.

United States v. Morrison (1976)

Appellant Boscia was convicted by a jury of both conspiracy to distribute and the distribution of hashish.[1] During the trial, the Assistant United States Attorney sent at least three messages to Bell, appellant's key witness,[2] warning her that if she testified, she could be prosecuted on drug charges,[3] and that her testimony could be used as evidence against her.[4] The United States Attorney then subpoenaed the witness, and upon her appearance in his office, issued a barrage of warnings concerning the dangers of her testifying.[5] When eventually called to the witness stand, Bell invoked the fifth amendment privilege against self-incrimination more than thirty times, allegedly depriving appellant of much of the evidence he had expected to offer to the jury.[6]

Although terming the actions of the prosecutor improper, the trial judge denied appellant's motion for mistrial.[7] Post-trial motions for a judgment of acquittal, or in the alternative, for a new trial were also denied.[8] The United

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1. United States v. Morrison, 535 F.2d 223 (3d Cir. 1976).

2. *Id.* at 225. The witness was allegedly prepared to testify under oath that it was she, and not appellant Boscia, who had been involved in the conspiracy to sell hashish. *Id.*

3. *Id.* Originally, the witness had been indicted with the appellant, but the federal charges against her had been dropped prior to the commencement of his trial. *Id.*

4. *Id.*

5. *Id* at 226. The prosecutor had compelled the witness' presence in his office through the use of an invalid subpoena, on which the witness' name had been inserted over one which had been scratched out. *Id.* Evidently, the sole purpose of the subpoena was to intimidate the witness in order to prevent her from testifying. *Id.* at 225–26. The Third Circuit noted that, in fact, the witness felt increasingly intimidated by the prosecutor's continued warnings. *Id.* at 226. The traditional rule has been that whether a witness is advised of his privilege against self-incrimination lies in the court's discretion. *See, e.g.,* United States v. Luxenberg, 374 F.2d 241, 246 (6th Cir. 1967) (witness before grand jury need not be advised).

6. 535 F.2d at 226. The defendant's right to place evidence before the jury was clearly established in Washington v. Texas, 388 U.S. 14 (1967), where the Supreme Court stated:

> The right to offer the testimony of witnesses, and to compel their attendance, if necessary, is in plain terms the right to present a defense, the right to present the defendant's version of the facts as well as the prosecution's to the jury so it may decide where the truth lies. Just as an accused has the right to confront the prosecution's witnesses for the purpose of challenging their testimony, he has the right to present his own witnesses to establish a defense.

Id. at 19. For a discussion of the impact of *Washington* and the compulsory process clause of the sixth amendment, *see* Western, *The Compulsory Process Clause,* 73 MICH. L. REV. 71, 111–17 (1974–75).

7. 535 F.2d at 224–25.

8. *Id.* at 225. The district court denied the motions on the grounds that the prosecutor had acted in good faith, and that his actions neither deprived appellant of any right to which he was entitled nor caused him substantial prejudice. *Id.* at 227.

States Court of Appeals for the Third Circuit[9] reversed the district court's denial of a new trial, *holding* that the actions of the prosecuting attorney deprived appellant of his constitutional right to call witnesses on his own behalf and elicit their freely given testimony. *United States v. Morrison*, 535 F.2d 423 (3d Cir. 1976).

The Third Circuit found that the instant case was controlled by *Webb v. Texas*,[10] where the trial judge's intimidation of the defendant's sole witness[11] was held by the Supreme Court to have deprived petitioner of due process of law by denying him the opportunity to present witnesses in his own defense.[12] The district court in *Morrison* had distinguished *Webb* in that the witness did testify,[13] the prosecutor may have acted in good faith,[14] and the warnings to the witness were issued by the prosecuting attorney rather than the trial judge.[15] The Third Circuit, however, did not find these factual distinctions to be relevant to the issue of whether the appellant had been denied a fair trial.[16]

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9. The case was heard by Judges Forman, Gibbons, and Rosenn. Judge Forman authored the majority opinion; Judge Rosenn dissented.

10. 409 U.S. 95 (1972).

11. In *Webb*, the sole defense witness was subjected to a prolonged warning by the trial judge of the dangers of perjury. 409 U.S. at 97. In addition, the judge implied that he fully expected that the testimony would be perjured. *Id.* Finally, the judge instructed the witness, who had a prior criminal record and was then serving a prison sentence, that a conviction on a perjury charge would be added to his present sentence, resulting in an impairment of his chances for parole. *Id.* The Supreme Court, in reversing the conviction, held that the judge's threatening remarks effectively drove the witness from the stand, thus depriving the defendant of due process of law under the fourteenth amendment of the United States Constitution. *Id.* at 98.

12. *Id.* at 97–98; *see* note 6 *supra*.

13. 535 F.2d at 227. The Third Circuit ruled that although Bell did testify on certain matters, the pressure imposed upon her by the prosecutor inhibited the voluntariness of her testimony and thereby infringed upon the defendant's sixth amendment right to have the benefit of her freely given testimony. *Id.* at 228.

14. *Id.* The preoccupation with the good faith of the prosecutor as a guide for reversal or affirmance on appellate review is evident historically. *See* Singer, *Forensic Misconduct by Federal Prosecutors — and How It Grew*, 20 ALA. L. REV. 227, 269–72 (1968). Some courts have taken the position that the intention of the prosecutor should be irrelevant in appellate review since the issue is fairness to the defendant, not discipline of the prosecutor. *See, e.g.*, Griffin v. United States, 183 F.2d 990 (D.C. Cir. 1950); United States v. Nettl, 121 F.2d 927, 930 (3d Cir. 1941); United States v. Sprengel, 103 F.2d 876 (3d Cir. 1939). *See generally* Note, *The Nature and Consequences of Forensic Misconduct in the Prosecution of a Criminal Case*, 54 COLUM. L. REV. 946 (1954).

On the other hand, good faith of the prosecutor has been a consideration in whole or part for affirmance. *See, e.g.*, Gladden v. Frazier, 388 F.2d 777 (9th Cir. 1968); Keeble v. United States, 347 F.2d 951 (8th Cir. 1965); Nicholson v. United States, 221 F.2d 281 (8th Cir. 1955); United States v. Antonelli Fireworks Co., 155 F.2d 631 (2d Cir.), *cert. denied*, 329 U.S. 742 (1946). At least one commentator has argued that the prosecutor's intent should be a relevant consideration in a close case. *See* Alschuler, *Courtroom Misconduct by Prosecutors and Trial Judges*, 50 TEX. L. REV. 629, 645–47 (1972).

15. 535 F.2d at 228. While the prosecutor in the instant case was "somewhat lower in the hierarchy" than the trial judge in *Webb*, the *Morrison* court noted that both figures represent symbols of the state's authority to prosecute wrongdoers. *Id.*

16. *Id.* at 227. The decision reached in *Morrison* is supported by several other recent cases. *See, e.g.*, United States v. Smith, 478 F.2d 976 (D.C. Cir. 1973). In *Smith*, the prosecutor had warned a witness that if he testified, he could and would be

Apparently, at least one factor in the *Morrison* court's decision was that the actions of the prosecutor were wholly unnecessary to effectuate any legitimate purpose.[17] Despite a finding of prosecutorial misconduct, the Third Circuit could have affirmed the appellant's conviction under the harmless error rule.[18] The court noted, however, that in *Webb*, a majority of the Supreme Court had required reversal despite the presence of what Justice Blackmun termed "overwhelming evidence of guilt."[19] The Third

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prosecuted as an accessory to murder. *Id.* at 977-78. The court found such action prejudicial and violative of the defendant's constitutional right to have witnesses testify free from intimidation. *Id.* at 979. *See also* Bray v. Peyton, 429 F.2d 500 (4th Cir. 1970) (arrest of defense witness during trial denied accused due process); People v. Pena, 383 Mich. 402, 175 N.W.2d 767 (1970) (prosecuting attorney's letters to important defense witnesses, calling their attention to statute making perjury a felony punishable by life imprisonment, were prejudicial, requiring a new trial). *But see* Commonwealth v. DiGiacomo, 463 Pa. 449, 345 A.2d 605 (1975) (defendant's sixth amendment right to present witnesses not infringed when prosecutor advised eyewitness of his fifth amendment right to refuse to testify).

17. 535 F.2d at 227. The Third Circuit noted that the issue of instructing Bell of her rights arose at the outset of the trial, and the trial judge stated that the court would instruct her on her rights at the proper time. *Id.* In addition, the instruction was in fact given by the trial judge to the witness before she took the stand. *Id.* at 228; *accord,* United States v. Smith, 478 F.2d 976 (D.C. Cir. 1973). The court in *Smith* emphasized: "If the prosecutor thought the witness should be advised of his rights then he should have suggested that the court explain them. . . . The matter would then have been presented . . . without any threats or implications of retaliation." *Id.* at 979.

It is also relevant that the *Webb* standard has been summarized as forbidding practices unnecessary to effectuate a legitimate governmental objective if a material witness is thereby deterred from testifying. *See* Western, *supra* note 6, at 140-41. Since the Third Circuit in *Morrison* had already determined that the prosecutor's actions were completely unnecessary, the *Webb* standard would apparently be invoked by the additional finding that a defense witness was "deterred" by those actions.

18. FED. R. CRIM. P. 52(a). Rule 52(a) provides: "Harmless Error. Any error, defect, irregularity or variance which does not affect substantial rights shall be disregarded." *Id.*

Normally, when evidence of a defendant's guilt is overwhelming, or if the reviewing court determines that the misconduct did not affect the verdict, affirmance under this rule can be justified. *See* United States v. Jenkins, 436 F.2d 140 (D.C. Cir. 1970) (prosecutor's characterization of defendant as a teenage hoodlum deemed harmless error); Taylor v. United States, 413 F.2d 1095 (D.C. Cir. 1969) (prosecutor's statement that defendant stabbed, shot, and kicked the victim "like a dog" not reversible error). *But see* United States v. Phillips, 476 F.2d 538 (D.C. Cir. 1973) (prosecutor's comparison between the defendant and Sirhan Sirhan, James Earl Ray, and Jack Ruby required reversal). *See also* Note, *The Nature and Consequences of Forensic Misconduct in the Prosecution of a Criminal Case,* 54 COLUM. L. REV. 946, 959-60, 970-71 (1954); Note, *Prosecutorial Misconduct — Recent Second Circuit Cases,* 2 HOFSTRA L. REV. 385, 401-04 (1974).

In Chapman v. California, 386 U.S. 18, 24 (1967), the Supreme Court had stated that the standard for harmless errors was whether it was clear "beyond a reasonable doubt that the error complained of did not contribute to the verdict obtained." *Id.* at 24. Although the district court in *Morrison* found that corroboration of appellant's story by the witness would not have affected the final verdict, the Third Circuit emphasized that the Government's interference with appellant's rights was too serious to be excused. 535 F.2d at 227.

19. 535 F.2d at 228, *quoting* Webb v. Texas, 409 U.S. 95, 99 (1972) (Blackmun, J., dissenting).

Circuit viewed the action of the Supreme Court as precluding a finding of harmless error when, by the actions of the Government, a defense witness is prevented from testifying freely.[20]

In failing to find harmless error under the circumstances present in *Morrison,*[21] while extending *Webb* to cover cases of prosecutorial misconduct,[22] it is submitted that *Morrison* has eliminated some of the distinctions which have heretofore been drawn between judicial and prosecutorial misconduct for purposes of appellate review.[23] The Third Circuit's overriding concern was to protect the defendant's constitutional right to present witnesses who are free from intimidation.[24] After *Morrison,* it is probable that prosecutorial intimidation will not be tolerated if, in fact, it can be shown that the testimony of defense witnesses might have been adversely affected.

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20. 535 F.2d at 228, *citing* Webb v. Texas, 409 U.S. 95, 99 (1972), *and* United States v. Thomas, 488 F.2d 334 (6th Cir. 1973) (prosecutor's admonishments to defense witness constituted prejudicial error even though guilt was overwhelming).

The Third Circuit has found prosecutorial misconduct improper, but not prejudicial, in a number of cases. *See, e.g.,* United States v. Somers, 496 F.2d 723 (3d Cir.), *cert. denied,* 419 U.S. 832 (1974) (prosecutor's improper remarks during opening argument, trial, and closing argument were not prejudicial); United States v. LeFevre, 483 F.2d 477 (3d Cir. 1973) (prosecutor's improper remarks as to guilt and credibility of accused did not constitute reversible error); United States v. Benson, 487 F.2d 978 (3d Cir. 1973) (improper summation not so gross as to constitute prejudicial error).

In other cases, the Third Circuit has held that prosecutorial misconduct required reversal. *See, e.g.,* United States v. Newmann, 490 F.2d 139 (3d Cir. 1974) (prosecutor's improper closing remarks were prejudicial and one factor leading to reversal); United States v. Small, 443 F.2d 497 (3d Cir. 1971) (prosecutor's representation in closing argument on evidence not in the record was extremely prejudicial).

21. 535 F.2d at 228.

22. *Id.*

23. Appellate courts have exhibited a greater willingness to find prejudicial error in cases of judicial misconduct since juries are thought to be more attentive to the views and prejudices of the trial judge than to those of the prosecutor and since the former are less subject to corrective measures at the trial level. Alschuler, *supra* note 14, at 684–90. It has been noted that the selective application of the harmless error doctrine presents the most striking difference between cases involving judicial, as distinguished from prosecutorial, misconduct. *Id.* at 689–90.

24. 535 F.2d at 228. Judge Rosenn, in his dissenting opinion, acknowledged this right, but stated that a defendant does not have cause to complain when his witness freely exercises the privilege to plead the fifth amendment. *Id.* at 229 (Rosenn, J., dissenting). Judge Rosenn distinguished *Webb* from the instant case on the basis that, unlike the witness who was driven from the stand in *Webb,* the witness in *Morrison* appeared in court for the defense, testified for the defense, and, in refusing to respond to certain questions, was exercising her fifth amendment privilege precisely as she was instructed was her right by the trial judge. *Id.* at 230.

Initially, the majority opinion did not address the conflict between the witness' fifth amendment privilege and the defendant's sixth amendment right to present witnesses in his defense. The fact that the witness' decision whether or not to testify could not be made "freely" due to the prosecutor's misconduct was apparently sufficient infringement upon the appellant's due process rights to require the granting of a new trial. *See id.* at 228. The issue of whether the witness would have taken the fifth amendment regardless of the warnings issued by the prosecutor was evidently irrelevant. *Id.* at 228–31.

In the final portion of the majority opinion, which dealt with the question of whether a fair trial of appellant was presently possible, the majority confronted the

In conclusion, it is submitted that still more guidelines need to be established. *Webb* dealt with extreme judicial misconduct, while *Morrison* was concerned with outrageous and unnecessary prosecutorial misconduct. Future cases will undoubtedly arise in which the conduct of a prosecutor may be improper, yet not so extreme as to mandate reversal on the basis of *Morrison*. In these instances, criminal defendants will continue to raise difficult questions by asserting prosecutorial misconduct as a basis for appellate review.

Ira J. Rappeport

CRIMINAL LAW — FIFTH AMENDMENT — FEDERAL WAGERING TAX — COLLATERAL RELIEF AVAILABLE TO VACATE CONVICTION BASED UPON GUILTY PLEA TO VIOLATION OF STATUTE REQUIRING INCRIMINATORY ACT.

United States v. Sams (1975)

In 1963, Victor Carlucci was sentenced to pay a fine of $10,000[1] after entering a guilty plea to an indictment charging him with willful failure to pay the special federal occupational tax on wagering.[2] The allegations which supported the indictment were based on his failure to register as a gambler[3] and his failure to pay the occupational tax for being a gambler[4]

conflict between the rights of the defendant and his witness, resolving it on the basis of use immunity. *Id.* at 228–29. Judge Forman stated that there are circumstances in which due process may require a prosecutor to request use immunity for a defense witness. *Id.* at 229. The prosecutorial misconduct in the instant case created such a circumstance; the witness refused to testify on certain matters because of her fear of self-incrimination, thereby depriving the defendant of favorable evidence. *Id.*

For an excellent discussion of the conflict between fifth and sixth amendment rights, *see* Western, *supra* note 6, at 166–170, 177.

1. United States v. Sams, 521 F.2d 421, 423 (3d Cir. 1975).

2. *Id.* at 423. Carlucci was indicted under section 7201 of the Internal Revenue Code (attempt to evade or defeat tax), section 7203 (willful failure to file return, supply information, or pay tax), section 7262 (violation of occupational tax laws relating to wagering — failure to pay special tax), and section 371 of title 18, United States Code (conspiracy to commit offense or to defraud United States). *Id.* at 423 n.1. He pleaded guilty to and was convicted under section 7203. *Id.*

3. *Id.* Section 4412 of the Internal Revenue Code requires that a gambler register certain information about himself and his business with the Internal Revenue Service. *See* I.R.C. § 4412. The name and address of the registrant are required as well as the names and addresses of those who work for the registrant and for whom he works in the business of wagering. *Id.*

4. 521 F.2d at 423 n.1. Section 4411 of the Internal Revenue Code requires that a gambler pay an occupational tax of $50 per year. I.R.C. § 4411.

and the excise tax on wagers placed with him.[5] Almost twelve years later, Carlucci filed an application for a writ of *coram nobis*[6] in federal district court for the Western District of Pennsylvania in which he asked that his conviction be set aside and the fine be refunded[7] on the grounds that since the Supreme Court had decided, subsequent to his conviction, that the statutes which he was charged with violating required the giving of incriminating information and that the fifth amendment was a complete defense to a charge of noncompliance, had Carlucci raised the fifth amendment defense, he could not have been convicted.[8]

The district court ruled that as Carlucci's guilty plea constituted a waiver of the privilege against self-incrimination,[9] and as there had been no congressional waiver of sovereign immunity,[10] the court lacked the authority to vacate his conviction and order the return of the fine.[11] On appeal, the United States Court of Appeals for the Third Circuit[12] reversed, *holding* that Carlucci's guilty plea did not prevent him from asserting his fifth amendment defense on collateral review since the very institution of the prosecution against him violated his privilege against self-incrimination. *United States v. Sams*, 521 F.2d 421 (3d Cir. 1975).

The Supreme Court had dealt with the tension between an individual's fifth amendment rights and Congress' power to tax and to regulate certain unlawful activities through taxation legislation a decade before Carlucci's

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5. 521 F.2d at 423 n.1. Section 4401 of the Internal Revenue Code requires that those involved in gambling and wagering activities pay a two percent excise tax on all wagers. I.R.C. § 4401.

6. The All Writs Act provides that the "Supreme Court and all courts established by Act of Congress may issue all writs necessary or appropriate in aid of their respective jurisdictions and agreeable to the usages and principles of law." 28 U.S.C. § 1651(a) (1970).

A writ of *coram nobis* is a writ of error directed to a court for an alleged error of fact not appearing on the record. BLACK'S LAW DICTIONARY 406, 175–86 (4th ed. 1968). It is presumed that the error would not have been committed had the fact been known to the court at the time. *Id.*

The use of a writ of *coram nobis* to test the validity of a conviction was upheld by the Supreme Court in United States v. Morgan, 346 U.S. 502 (1954); *see* Lawson v. United States, 397 F. Supp. 370 (N.D. Ga. 1975), in which a federal district court allowed a defendant to proceed by a writ of *coram nobis* in a situation almost identical to that found in the instant case.

7. 521 F.2d at 423.

8. *Id.* at. 423–24. Carlucci also founded his action upon section 1346(a)(2) of the Tucker Act which provides:

> The district courts shall have original jurisdiction, concurrent with the Court of Claims, of:
>
> . . . .
>
> (2) Any other civil action or claim against the United States, not exceeding $10,000 in amount, founded either upon the Constitution, or any Act of Congress, or any regulation of an executive department, or upon any express or implied contract with the United States, or for liquidated or unliquidated damages in cases not sounding in tort.

28 U.S.C. § 1346(a)(2) (1970).

9. 521 F.2d at 424.

10. *Id.*

11. *Id.*

12. The case was heard by Judges Van Dusen, Adams, and Garth. Judge Adams wrote the court's opinion.

conviction in *United States v. Kahriger*.[13] There the Court held that the federal wagering tax statute did not contravene an individual's fifth amendment rights.[14] However, in 1968, the Court overruled *Kahriger* in *Marchetti v. United States*[15] and *Grosso v. United States*,[16] both of which involved defendants who had been convicted of failing to register and pay the special taxes on wagering.[17] In separate opinions, the Court held that the assertions of the privilege against self-incrimination constituted a complete defense to prosecution.[18]

The Supreme Court applied the *Marchetti* and *Grosso* rationale one year later in *Leary v. United States*,[19] which involved a defendant who had been convicted of failing to pay the federally required transfer tax on marijuana.[20] The Court in *Leary* interpreted the defendant's assertion of his fifth amendment privilege not as a claim that he had the right to remain silent at trial, but rather as a claim that he had a right not to be held criminally liable for his failure to comply with a statute which required an incriminatory act.[21]

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13. 345 U.S. 22 (1953), *overruled in part,* Marchetti v. United States, 390 U.S. 39, 54 (1968); *see* notes 15, 17 & 18 and accompanying text *infra.*

14. 345 U.S. at 32–33. In his dissenting opinion in *Kahriger,* Justice Black stated: "[W]e have a Bill of Rights that condemns coerced confessions, however refined or legalistic may be the technique of extortion. I would hold that this Act violates the Fifth Amendment." *Id.* at 37.

The approach taken by the majority in *Kahriger* was followed in Lewis v. United States, 348 U.S. 419 (1955), *overruled in part,* Marchetti v. United States, 390 U.S. 39, 54 (1968). Justice Black again expressed dismay that an individual could be sent to jail for refusal to publicly register information descriptive of his criminal conduct. *Id.* at 425 (Black, J., dissenting). Justice Black's reasoning was finally adopted by the Court in Marchetti v. United States, 390 U.S. 39 (1968); *see* notes 15, 17 & 18 and accompanying text *infra.*

15. 390 U.S. 39 (1968). The *Marchetti* Court held that a proper and timely assertion of one's constitutional privilege against self-incrimination was a complete defense to charges of violating the provisions of federal wagering tax statutes governing registration and payment of occupational tax. *Id.* at 60–61.

16. 390 U.S. 62 (1968). *Grosso* originated out of the Third Circuit which had affirmed the district court's conviction of the defendant for violation of the Gambling Tax Act of 1954 and for conspiracy to defraud the United States and held that the defendant could not raise a fifth amendment defense to the charge of failure to pay taxes on gambling. United States v. Grosso, 358 F.2d 154, 164 (3d Cir. 1966). The Supreme Court heard the *Grosso* case with *Marchetti,* and held that the defendant could not be prosecuted for failure to register as a wagerer and to pay the special taxes on wagering. 390 U.S. at 64–72.

17. *Marchetti,* 390 U.S. at 40–41; *Grosso,* 390 U.S. at 63; see notes 3–5 *supra.*

18. *Marchetti,* 390 U.S. at 50–54; *Grosso,* 390 U.S. at 71–72. The Court concluded in *Marchetti* that "nothing in the Court's opinions in *Kahriger* and *Lewis* now suffices to preclude petitioner's assertion of the constitutional privilege as a defense to the indictments under which he was convicted. To this extent *Kahriger* and *Lewis* are overruled." *Id.* at 54.

19. 395 U.S. 6 (1969).

20. *Id.* at 11. The defendant in *Leary* had also been convicted of knowingly smuggling marijuana into the United States and thereafter transporting and concealing it. *Id.* at 10. The *Leary* Court reversed and remanded on these two counts. *Id.* at 53–54.

Internal Revenue Code sections 4741 through 4746, 4751 through 4757, 4761, 4762, and 4771 through 4776, all of which dealt with the tax aspects regarding the transfer of marijuana, were repealed in 1970 as a result of the fifth amendment defects made apparent by *Leary.* Pub. L. No. 91–513, 84 Stat. 1292 (1970).

21. 395 U.S. at 28.

The holdings of *Marchetti* and *Grosso* were given retroactive effect by the Supreme Court in *United States v. United States Coin & Currency.*[22] Similarly, the *Leary* case was given retroactive application by the Third Circuit in *Bannister v. United States.*[23] As in *Leary, Bannister* involved a defendant who had pleaded guilty to concealing and transporting marijuana without paying the transfer tax.[24] The court held that the defendant should be able to assert his right against self-incrimination in a collateral attack on his conviction because, had this right been recognized at the time he was prosecuted, he could never have been convicted.[25]

Soon after its decision in *Leary,* the Supreme Court held in the 1970 trilogy of *Brady v. United States,*[26] *McMann v. Richardson,*[27] and *Parker v. North Carolina*[28] that collateral attack by a defendant was not available where the conviction was based upon a guilty plea voluntarily and intelligently made.[29] In all of these cases the Court focused upon the degree to which the alleged unconstitutional governmental techniques had coerced

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22. 401 U.S. 715 (1971). This was a proceeding by the United States involving the forfeiture of money to the government. *Id.* at 716. The money was allegedly used by one who failed to register and pay the occupational tax on wagering. *Id.* at 715. Justice Harlan, writing for the Court, stated: "*Marchetti* and *Grosso* dealt with the kind of conduct that cannot constitutionally be punished in the first instance. . . . [W]e have held that the conduct being penalized is constitutionally immune from punishment. No circumstances call more for the invocation of a rule of complete retroactivity." *Id.* at 723–24.

The usual standards for applying a decision retroactively had been established by the Supreme Court in Stovall v. Denno, 388 U.S. 293 (1967). There the Court articulated three factors governing the propriety of retroactive application: "(a) the purpose to be served by the new standards, (b) the extent of the reliance by law enforcement authorities on the old standards, and (c) the effect on the administration of justice of a retroactive application of the new standards." *Id.* at 297. In response to the majority's reliance upon these factors, Justice Brennan, in his concurring opinion in *United States Coin & Currency,* stated that the usual standards were irrelevant in that the Court's decision "established beyond peradventure that the government has no legitimate interest in punishing such conduct at all." 401 U.S. at 727.

For a succinct review of the Supreme Court cases dealing with the question of retroactivity, *see* United States v. United States Coin & Currency, 401 U.S. 715, 728–38 (1971) (Brennan, J., concurring).

23. 446 F.2d 1250 (3d Cir. 1971).

24. *Id.* at 1250, 1256–57.

25. *Id.* at 1257–63.

26. 397 U.S. 742 (1970). In *Brady,* the Court refused to label the defendant's guilty plea as involuntary even though the defendant argued that it was given in response to a statute, later declared unconstitutional, which gave a jury, but not a judge, the option of invoking the death penalty for the crime of kidnapping. *Id.* at 745–48. The defendant contended that he pleaded guilty to avoid a jury trial. *Id.* at 744.

27. 397 U.S. 759 (1970). In *McMann,* the defendant argued that his original guilty plea followed an allegedly coerced confession. *Id.* at 762. The Court looked not to the confession, but to whether the guilty plea was entered voluntarily and intelligently. *Id.* at 771–74.

28. 397 U.S. 790 (1970). The challenge in *Parker* was a synthesis of the arguments put forth by the defendants in *Brady* and *McMann.* Parker argued that he pleaded guilty because the statute proscribing first degree burglary gave a jury, but not a judge, the right to invoke the death penalty. *Id.* at 794. He also argued that his guilty plea followed a coerced confession. *Id.*

29. *Brady,* 397 U.S. at 756–58; *McMann,* 397 U.S. at 766–68; *Parker,* 397 U.S. at 796–98.

the guilty pleas[30] and determined that the pleas had been voluntary and knowing in nature and that they had not been coerced by these alleged techniques.[31] Three years later the Court reiterated this emphasis in *Tollett v. Henderson.*[32]

In 1974, the Court slightly modified the position it had taken in the trilogy cases in *Blackledge v. Perry.*[33] There the Court held that even though a guilty plea had been entered, the conviction could be collaterally attacked if the integrity of that conviction was in question[34] — that is, if the nature of the underlying constitutional infirmity was so egregious that the state had no right to prosecute in the first place.[35]

It was against this historical framework that the Third Circuit was faced with the task of determining the effect of Carlucci's guilty plea on the availability of collateral relief.[36] More particularly, the court was confronted with the question of whether Carlucci's guilty plea was knowing and voluntary in light of the fact that at the time of his conviction, *Marchetti* and *Grosso* had not yet been decided, and thus Carlucci could not have known that his fifth amendment right to remain silent would have provided him with a complete defense to the charges against him.[37]

30. *Brady,* 397 U.S. at 749–55; *McMann,* 397 U.S. at 769–71; and *Parker,* 397 U.S. at 794–96. The allegedly coercive techniques were: 1) that the sentencing statutes for certain felonies which gave a jury, but not a judge, the right to impose a death penalty forced defendants to forego a jury trial rather than risk a death sentence, and 2) that unlawfully extracted confessions from defendants are used to induce guilty pleas. *Brady,* 397 U.S. at 743; *McMann,* 397 U.S. at 762; *Parker,* 397 U.S. at 794.

31. *Brady,* 397 U.S. at 758; *McMann,* 397 U.S. at 768–69; *Parker,* 397 U.S. at 794–96.

32. 411 U.S. 258 (1973). In *Tollett* the right to be indicted by a constitutionally selected grand jury — one selected in a nondiscriminatory manner — had been recognized prior to defendant's indictment. *Id.* at 261. Tollett's attorney, however, was not aware and did not advise his client that the state systematically excluded blacks from the grand jury. *Id.* at 266. The Court decided that Tollett could attack his guilty plea only on the basis of its voluntariness and the competency of his counsel and could not attack it as an unknowing waiver. *Id.* at 266–68.

33. 417 U.S. 21 (1974). The defendant, convicted of a misdemeanor, was threatened with having to defend a felony charge if he exercised his constitutional right and requested a new trial. *Id.* at 23. He pleaded guilty to the felony charge and subsequently sought federal habeas corpus on the ground that the felony indictment deprived him of due process because it punished him for exercising his statutory right to a trial de novo. *Id.* at 25.

34. *Id.* at 30–31.

35. *Id.* at 31.

36. Neither the Supreme Court nor the Third Circuit had decided this issue in any case factually similar to the instant case. An almost identical set of facts was involved, however, in a case decided a month before *Sams,* Lawson v. United States, 397 F. Supp. 370 (N.D. Ga. 1975). Despite the factual similarity to *Sams,* the *Lawson* court did not discuss the problem of the guilty plea. The Government had conceded that the fifth amendment would have provided a complete defense for the defendant and that the availability of such a defense was retroactive. *Id.* at 371. For these reasons, the court held that Lawson's conviction could not stand. *Id.* at 371–72.

37. 521 F.2d at 424. Carlucci argued that a right not yet recognized could not have been known to him when he pleaded guilty and, therefore, could not have been waived. *Id.* In 1938, the Supreme Court defined "waiver" as "an intentional relinquishment or abandonment of a known right or privilege." Johnson v. Zerbst, 304 U.S. 458, 464 (1938); *cf.* Tollett v. Henderson, 411 U.S. 258 (1973) (defendant's guilty plea held to be waiver even though he was unaware of right which he was waiving).

The Third Circuit recognized that the Supreme Court had greatly limited the availability of collateral relief following guilty pleas to those situations in which the defendant could "show that he did not make the plea knowingly, intelligently and voluntarily or upon a demonstration that the plea was not uttered with the assistance of counsel competent with respect to the law as it existed at the time of the conviction."[38] However, rather than applying the test of voluntariness to the guilty plea, the Third Circuit interpreted its prior holding in *Bannister* to require an examination of the quality of the right being asserted in the collateral attack.[39] According to the court, such an examination necessitated a determination of whether the newly expressed right affected " 'the integrity of the conviction' " or instead constituted an " 'essentially procedural change in the law.' "[40] In this regard, the Third Circuit agreed that the constitutional objection raised by Carlucci — that the fifth amendment should have barred his prosecution — undermined the integrity of his conviction,[41] and noted that the right asserted was identical to that asserted in *Bannister* — "freedom from criminal punishment for not incriminating one's self by paying a special tax on an activity closely circumscribed by criminal penalties."[42]

In response to the Government's argument that the *Bannister* rationale had been undermined by the Supreme Court's decision in *Tollett v. Henderson*,[43] where the Court held that to determine whether there has been a waiver of a constitutional right, the focus should not be on "the existence . . . of an antecedent constitutional infirmity,"[44] the Third Circuit distinguished the instant case from *Tollett* as well as from *Brady*,[45] *McMann*,[46] and *Parker*[47] on the basis that those cases were grounded on objections to procedural rather that substantive constitutional infirmities which may or may not have rendered the guilty pleas involuntary,[48] whereas the assertion in the instant case was that the very conduct with which Carlucci was

38. 521. F.2d at 424.
39. *Id.* at 425, *citing* Smith v. Yeager, 459 F.2d 124, 126 (3d Cir. 1972).
40. 521 F.2d at 425, *quoting* Smith v. Yeager, 459 F.2d 124, 126 (3d Cir. 1972).
41. 521 F.2d at 425.
42. *Id.*
43. 411 U.S. 258 (1973); *see* note 32 *supra*.
44. 411 U.S. at 266.
45. *See* notes 26 & 29–31 and accompanying text *supra*.
46. *See* notes 27 & 29–31 and accompanying text *supra*.
47. *See* notes 28–31 and accompanying text *supra*.
48. 521 F.2d at 425–26; *see* note 30 *supra*. Justice Harlan distinguished these procedural and substantive issues by defining procedural due process rules as

> those applications of the Constitution that forbid the Government from utilizing certain techniques or processes in enforcing concededly valid societal proscriptions on individual behavior. New "substantive due process" rules, that is, those that place, as a matter of constitutional interpretation, certain kinds of primary, private individual conduct beyond the power of the criminal lawmaking authority to proscribe, must [in Justice Harlan's view] be placed on a different footing. . . . [He concluded that] the obvious interest in freeing individuals from punishment for conduct that is constitutionally protected seem[ed] to him sufficiently substantial to justify applying current notions of substantive due process to petitions for habeas corpus.

Bannister v. United States; 446 F.2d 1250, 1262–63 (3d Cir. 1971), *quoting* Mackey v. United States, 401 U.S. 667, 692–93 (1971) (Harlan, J., concurring).

charged was constitutionally privileged.[49] To further distinguish those four cases, the court looked to the type of conduct proscribed by the statutes in question and noted that the defendants in *Brady, McMann, Parker,* and *Tollett* were charged with crimes in which the Government had an "interest in continuing to punish the offender"[50] — kidnapping,[51] burglary,[52] and murder.[53] In Carlucci's case, however, the court stated that the Government no longer had a legitimate interest in the conduct charged against him "since the Supreme Court has held that the conduct in question is not constitutionally punishable."[54] Moreover, the court noted that there was no way to determine whether the defendant in *Tollett* would have exercised his constitutional right even if he had been aware of it,[55] while in *Sams* there was little question that had Carlucci known of his fifth amendment right under *Marchetti,* he would not have pleaded guilty but would have instead exercised his fifth amendment privilege, for to do so would have been a complete defense to the charges against him.[56] Accordingly, on the basis of the continuing vitality of *Bannister* and in light of the various distinguishing features between that case and *Tollet,* the Third Circuit found that Carlucci's guilty plea was subject to collateral attack.[57]

The Third Circuit's decision that collateral attack is available enables a defendant in that circuit who prior to the *Sams* case pleaded guilty to a violation of federal wagering tax statutes to have his conviction vacated without proving that he did not knowingly, intelligently, and voluntarily waive his fifth amendment defense when he pleaded guilty, and without

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49. 521 F.2d at 426.
50. *Id.*
51. Brady v. United States, 397 U.S. 742, 743 (1970).
52. Parker v. North Carolina, 397 U.S. 790, 792 (1970).
53. Tollett v. Henderson, 411 U.S. 258, 259 (1973).
54. 521 F.2d at 426; *see* notes 15–18 *supra.*
55. 521 F.2d at 426. The *Tollett* Court noted that a defendant might have chosen to plead guilty even if he had been aware of the fact that the system by which his indicting grand jury was chosen was racially discriminatory. 411 U.S. at 268.
56. 521 F.2d at 426. The *Sams* Court examined another case, Haynes v. United States, 390 U.S. 85 (1968), in which the Supreme Court did not hesitate to reverse a conviction based on a guilty plea that was in violation of the defendant's constitutional rights. *Id.* at 100–01. Haynes was charged with possession of an unregistered firearm. *Id.* at 86. He argued that compliance with the firearms registration statute would have required him to incriminate himself because the firearm in question was an illegal weapon. *Id.* at 95–96. The Supreme Court concluded that the fifth amendment was a complete defense to a charge of failure to register such a firearm. *Id.* at 95–100.

The Third Circuit likened Carlucci's assertion to that of the defendant in *Blackledge v. Perry,* in which the Supreme Court stated that the defendant was " 'not complaining of antecedent constitutional violations' " but rather was asserting " 'the right not to be haled into court,' " and it was on that basis that federal habeas corpus was available to the defendant. 521 F.2d at 428, *quoting* Blackledge v. Perry, 417 U.S. 21, 30–31 (1974), *quoting* Tollett v. Henderson, 411 U.S. 258, 266 (1973).
57. 521 F.2d at 428. The court denied relief, however, to Carlucci's claim for a refund of the fine, citing the expiration of the six-year statute of limitations. *Id.* at 430. Regardless of whether the right of action accrued at the time the fine was paid or at the time Carlucci became aware that he had been injured — when the *Marchetti* and *Grosso* decisions came down — more than six years had passed since either event. *Id.*

showing that the advice from his counsel was incompetent in light of the then-existing law.[58]

The defense of self-incrimination, raised by means of the proper writ, will enable the court to expunge the record without the necessity of a hearing.[59] Moreover, as a result of *Sams*, a defendant's prior conviction for failure to register or pay the federal wagering tax, if expunged, may not be used for impeachment purposes if the defendant is on trial for a similar charge, nor may it be used to increase his sentence.[60]

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58. The instant decision prevents Congress from requiring the performance of incriminatory acts under the guise of its taxing authority. Justice Brennan, concurring in *Grosso*, discussed the potential of the fifth amendment privilege to dilute Congress' regulatory authority:

> Of course the privilege does not guarantee anonymity. The question in these cases, however, is not whether all governmental programs which require citizens to expose their identity are invalid, but whether this statutory system, designed primarily for and utilized to pierce the anonymity of citizens engaged in criminal activity, is invalid. The privilege does guarantee anonymity from inquiries so designed, when the risks are not wholly fanciful. And the risks here are obvious and real. A list of persons who comply with § 4401 every month is invaluable to prosecuting authorities. It must frequently provide the clinching link in the chain of conviction.
>
> We must take this statute as it is written and as it has been applied. Both the statute and the practice under it clearly further a congressional purpose to gather evidence from citizens in order to secure their conviction of crime. There undoubtedly will be other statutes and practices as to which this determination will be more difficult to make. These cases, however, present a statutory system manifesting a patent violation of the privilege. That system must be dealt with uncompromisingly to protect against encroachment of the privilege and to encourage legislative care and concern for its continuing vitality.

390 U.S. at 75–76 (Brennan, J., concurring).

59. In a discussion of the procedure required to apply the fifth amendment defense retroactively to vacate convictions, Judge Biggs stated in *Bannister* that "as the Fifth Amendment is a complete defense to prosecution under Section 4744(a)(2), there will be no need for protracted evidentiary hearings upon applications for post-conviction relief." 446 F.2d at 1259. Thus, once a petitioner has raised the fifth amendment defense to attack a conviction entered prior to *United States Coin & Currency*, there seems to be no need for a hearing; the conviction would simply be vacated. The United States District Court for New Jersey explained its disposition of a defendant's petition to vacate his conviction:

> Therefore, there will be no need for an evidentiary hearing or retrial of this defendant or any other. Mere assertion of the privilege eradicates any authority the Government might have to prosecute. Additionally, the very nature of the crime is a failure to provide required information. The *Marchetti* and *Grosso* decisions indicate that this failure is now constitutionally protected.

United States v. Russo, 358 F. Supp. 436, 441 (D.N.J. 1973).

60. Some courts have expanded the *Sams* doctrine to expunge similar convictions when those guilty pleas were obtained as a result of plea bargaining. *See, e.g.*, United States v. Liquori, 430 F.2d 842 (2d Cir. 1970), *cert. denied*, 402 U.S. 948 (1971) (defendant's conviction for failure to pay transfer tax on marijuana vacated by court even though obtained by guilty plea made as a result of plea bargaining). *But see* United States v. Weber, 429 F.2d 148 (9th Cir. 1970), *vacated*, 402 U.S. 939 (1971) (conviction of defendant for failure to pay stamp tax on marijuana affirmed by court on grounds that guilty plea made as a result of plea bargain benefited defendant and was a complete waiver of fifth amendment defense).

Although the court in *Bannister* was not faced with this question, Judge Gibbons commented on the problem, noting that "[i]n view of those substantial benefits it is entirely reasonable that the government bear the risk that a statute to which it accepts a plea may later be held to be unconstitutional as applied to the defendant's conduct. Weighing the competing considerations we conclude that the

The *Sams* decision is subject to criticism, however, in light of the court's failure to consider the question of whether or not the fifth amendment defense *could* be waived. In *Bannister,* Judge Gibbons noted that "neither in *Leary* nor in *Marchetti,* [nor] *Grosso* . . . did the Supreme Court say squarely that statutes requiring conduct which for an individual would be self-incriminating were unconstitutional per se."[61] Therefore, it appears that the possibility of criminal prosecution for noncompliance with the federal wagering tax statutes exists for those who voluntarily choose to waive their fifth amendment privilege. Neither the Supreme Court in its decisions on this subject nor the Third Circuit considered the implications of a defendant's waiver of his privilege against self-incrimination in such a prosecution. Whether compliance by itself would be a waiver, and whether a defendant would be able to assert his fifth amendment defense if the information given in response to the wagering tax statutes were used against him in another prosecution, were questions left unanswered by the *Sams* court.

It is difficult to predict which statutes will prove as constitutionally frail as the wagering tax law involved in *Sams.* There may be situations where, although the required disclosure of basic information is incriminatory, the government's need to regulate is held to have a higher priority.[62]

In any factual situation where a constitutional deprivation is established and the right to redress is applied retroactively, the courts will still have to decide how to handle defendants' attacks upon convictions based on guilty pleas. The Third Circuit's decision in *Sams* aids in the identification of statutes which require incriminatory acts and as such may be vulnerable to attack, and also serves to establish a standard for vacating convictions under such statutes.

Moreover, as a result of *Sams,* prosecutors may no longer use these statutes as an incentive for plea bargaining without running the risk of having the conviction vacated in the future. In addition, defendants who were prosecuted as second offenders, where the first offense was a conviction under one of these statutes, may now have recourse in the courts to question

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government should bear this risk." 446 F.2d at 1265. In *Sams,* the Third Circuit did not discuss the issue, leaving open the question of whether or not a plea bargain would have affected the outcome of the case.

61. 446 F.2d at 1264. Justice Harlan spoke directly to the point while commenting on *Marchetti* and *Grosso* in *United States Coin & Currency:*

> It was only the method Congress had adopted in collecting the tax that raised the Fifth Amendment question. . . . Since it was only this method of tax collection which was subject to constitutional objection, we indicated that the Government remained free to collect taxes due under the statute so long as it did not attempt to punish the taxpayer for his failure to file the required documents.

401 U.S. at 717–18.

In no case has the Court directly confronted the question of whether or not voluntary compliance with the statute constitutes a waiver of the fifth amendment defense if the information submitted is used as evidence in another prosecution.

62. In such cases the government may immunize the information from any use other than the regulatory one. Use immunity has been offered as a possible compromise between the government's right to regulate and the individual's right to remain silent. *See* Comment, *Reporting Illegal Gains As Taxable Income: A Compromise Solution to a Prosecutorial Windfall,* 69 NW. U.L. REV. 111 (1974).

their status as second offenders and the penalties predicated upon such status. Ultimately, the judicial decisions prior to and including *Sams* which dealt with tax statutes requiring incriminatory acts may have the effect of ensuring that new statutes promulgated by Congress and implemented by the Internal Revenue Service will be drafted for the strict purpose of exercising the government's taxing authority and not for the purpose of detecting and punishing criminal activities.[63]

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63. For a discussion of the purposes and policies behind the fifth amendment privilege against self-incrimination in the area of use of tax returns in non-tax related criminal prosecutions, *see* Note, *The Use of Tax Returns in Non-Tax Prosecutions*, 41 BROOKLYN L. REV. 580 (1974).